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IN THE
Supreme Court of the United States
OCTOBER TERM, 1982

RAYMOND L. DIRKS,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The District Of Columbia Circuit

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DAVID BONDERMAN
Counsel of Record
LAWRENCE A. SCHNEIDER
ERIC SUMMERGRAD
ARNOLD & PORTER
1200 New Hampshire Ave., N.W.
Washington, D.C. 20036
(202) 872-6700
Attorneys for Petitioner
Raymond L. Dirks

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QUESTIONS PRESENTED

Did the Court of Appeals err in holding liable under the antifraud provisions of the securities laws an analyst—who repeated allegations of corporate fraud made by several former and present company employees, but denied by management, to many persons, some of whom later sold stock on the open market without disclosing the allegations—on the theory that:

(1) Employees of a registered broker-dealer are "required to meet a high standard of ethical behavior" and therefore automatically have "a duty to the [Securities and Exchange] Commission and the [general] public" that satisfies the fiduciary duty requirement of *Chiarella* v. *United States*, 445 U.S. 222 (1980)?

(2) Under *Chiarella* v. *United States*, *supra*, unverified allegations of fraud made by insiders necessarily carry with them a duty not to repeat the allegations to persons who may sell on the open market even if the analyst himself neither has any preexisting fiduciary duty nor obtains the allegations through any breach of an insider's fiduciary duty?

(3) Unverified allegations of fraud vigorously denied by management are nonetheless "material facts" under the securities laws and *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976)?

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Petitioner Raymond L. Dirks respectfully prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the District of Columbia Circuit in the above-entitled case.

OPINIONS BELOW

The March 29, 1982 judgment of the Court of Appeals is not reported; it is reprinted in the Appendix at page C-1. The May 18, 1982 opinion of the Court of Appeals is reported unofficially at [Current] Fed. Sec. L. Rep. (CCH) ¶ 98,669 and is reprinted in the Appendix beginning at page A-1. The opinion of the Securities and Exchange Commission is reported unofficially at [1981] Fed. Sec. L. Rep. (CCH) ¶ 82,812, and is reprinted in the Appendix beginning at page B-1. The Initial Decision of Administrative Law Judge David Markun is published in *In re Boston Company Institutional Investors, Inc., et al.*, [1978] Fed. Sec. L. Rep. (CCH) ¶ 81,705 (1978).

JURISDICTION

The judgment of a divided panel of the Court of Appeals (Judge Tamm dissenting) was entered on March 29, 1982. A timely Petition for Rehearing and Suggestion for Rehearing *En Banc* was filed on April 27, 1982. On May 18, 1982 Judge Wright filed an opinion in support of the judgment. Judge Robb concurred in the result only. Judge Tamm dissented. The Petition for Rehearing and Suggestion for Rehearing *En Banc* was denied on May 19, 1982. (App. C-2 and C-3) This petition is filed within 90 days of that denial. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS

This case involves Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a); Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b); and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5. The provisions of these statutes and regulation are set forth in the Appendix beginning at page D-1.

STATEMENT OF THE CASE

I. Proceedings Below

Petitioner Raymond L. Dirks is a professional investment analyst. In early March 1973 Dirks was contacted by a former employee of Equity Funding Corporation of America ("Equity Funding" or "EFCA"), which was a major insurance holding company listed on the New York Stock Exchange. This former employee told Dirks that he believed that Equity Funding was engaged in a massive fraud involving, among other things, the creation of fictitious insurance policies. Similar allegations had been investigated previously by the SEC, which had failed to substantiate them, and were at the same time again made to the SEC, which failed to act.

Dirks, however, investigated these allegations himself and also attempted to have them investigated and publicized by *The Wall Street Journal*. Some of the allegations turned out to be true; others proved to be false. Largely as a result of Dirks' efforts, one of the largest business frauds in history was uncovered.

In the course of his investigation, Dirks told many members of the investment community about the allegations of fraud. While most of these people discounted the unconfirmed allegations and some even bought Equity Funding stock after hearing them, others sold stock on the open market without disclosing the allegations. Neither Dirks nor his firm owned or traded any Equity Funding stock.

After the Equity Funding fraud was exposed, the SEC shocked the investment community by charging and then finding that Dirks had violated and aided and abetted violations of Section 10(b), Rule 10b-5, and Section 17(a) of the securities laws when he repeated the allegations of fraud to members of the investment community who later sold their Equity Funding stock.[1] Recognizing that Dirks played "an important role in bringing EFCA's massive fraud to light," that Dirks "reported the fraud allegations to EFCA's auditors and sought to have the information published in *The Wall Street Journal*," and that in twenty years as an analyst Dirks had an "unblemished" record, the Commission reduced the sanction imposed by an Ad-

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[1] Five sellers of Equity Funding securities were also named as respondents in the SEC administrative proceedings: The Boston Institutional Investors, Inc., The Dreyfus Corporation, John W. Bristol & Co., Tomlin, Zimmerman and Parmalee, Inc., and Manning and Napier, Inc. Four of the trading respondents were censured; no sanction was imposed on the fifth. None of them sought review of the Commission's decision.

ministrative Law Judge from a sixty-day suspension to a censure. (App. B-26)

In a three-paragraph judgment, a divided panel of the United States Court of Appeals for the District of Columbia Circuit denied Dirks' Petition for Review of the SEC decision on the ground—not mentioned at any point by the SEC—that Dirks "breached his duty to the Commission and to the public not to misuse insider information and that he was compensated for so doing." (App. C-1) After petitioner sought rehearing, Judge Wright issued a 41-page opinion in support of the judgment. Judge Robb concurred in the result only and Judge Tamm dissented.

Judge Wright noted in his opinion that this case involves "both sensational facts and difficult issues of law and policy." (App. A-2) Judge Wright observed that investment analysts can play an important independent role in ferreting out corporate fraud and conceded that "[l]argely thanks to Dirks one of the most infamous frauds in recent memory was uncovered and exposed, while the record shows that the SEC repeatedly missed opportunities to investigate Equity Funding." (App. A-3) Judge Wright also observed that the threat of liability under the antifraud provisions of the securities laws may impede such investigations in the future. (App. A-3)

Nevertheless, Judge Wright found that Dirks had breached a legal duty of disclosure that he owed "to the SEC and to the public" solely because he was an investment analyst employed by a broker-dealer, and as a member of the securities industry, was therefore "required to meet a high standard of ethical behavior." (App. A-27 to A-31) Judge Wright found that this duty to disclose was "created by the ethical standard that applies to broker-dealers" and that Dirks, in "failing to report promptly

what he knew" to the SEC and the public, breached this duty. (App. A-29, A-31)

Judge Wright also found that since Dirks had heard the allegations about fraud at Equity Funding from former employees and one present employee of Equity Funding, he was a "tippee" of corporate insiders. Because both federal and relevant state law require the disclosure of fraudulent management activities, both the SEC and Judge Wright conceded that these "insiders," in disclosing the alleged fraud to Dirks, had not breached any fiduciary duty. (App. A-23 to A-25) Moreover, it was undisputed that Dirks himself was a stranger with no preexisting fiduciary duty to seller or buyer. Nevertheless, Judge Wright found that Dirks had automatically acquired a fiduciary duty to "disclose or refrain" from trading on information acquired from the corporate insiders and that he breached that duty when he repeated the allegations to others, some of whom later sold Equity Funding stock.

Finally, Judge Wright found that the information in Dirks' possession constituted "material facts" for purposes of the securities laws, even though that information consisted of unverified allegations that did not come "from a source whose word would not be doubted." (App. A-34 to A-35)

II. Relevant Facts

The underlying facts, while "sensational," are largely not disputed. From the middle 1960s through the early 1970s, Equity Funding was regarded by the Wall Street investment community as a highly attractive "growth" company. In November 1971, the Los Angeles regional office of the Securities and Exchange Commission was told that Equity Funding's controller was making allega-

tions of fraud at the company, specifically that Equity Funding was overstating the amount of insurance in force by placing phony policies on its books. The SEC conducted an investigation, rejected an offer by the then former controller to provide information about substantial fraud at Equity Funding in exchange for immunity, found no incriminating evidence and closed its investigation. (J.A. 910-13)

On the morning of March 7, 1973, Ronald Secrist, a former employee of two of Equity Funding's life insurance subsidiaries, met with the New York Insurance Department and made allegations of fraud at Equity Funding in some detail, primarily to the effect that Equity Funding had phony policies on its books and that these policies were being sold to reinsurers as though they were real. These allegations were relayed to the California Department of Insurance, which in turn passed them on to the SEC on March 9, 1973. The SEC Los Angeles regional staff reported that they had previously heard similar allegations by disgruntled employees which did not prove out and recommended that any inspection of Equity Funding operations be delayed until the next year when more personnel would be available. The SEC took no action on the allegations. (J.A. 888-97, 898)[2] A number of state insurance departments did subsequently commence an intensive audit, but during the relevant time period found no evidence of wrongdoing. (J.A. 879-80)

However, also on March 7, 1973, Secrist conveyed the same allegations to Petitioner Dirks, who was then a highly respected securities analyst employed by Delafield Childs, a small Wall Street firm. Dirks was a specialist in

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[2] References are to the Joint Appendix filed with the Court of Appeals.

the insurance industry and had a reputation for conducting aggressive and independent investigations of the companies he reported on. (App. B-3)

Secrist told Dirks that he had recently left an Equity Funding subsidiary, Bankers National Life Insurance Co., in protest over the way it was operated, and that there was substantial financial manipulation occurring at Bankers Life. (In fact, it subsequently turned out that there was no substantial wrongdoing at Bankers Life and that Secrist had not resigned in protest but had been fired.) (J.A. 123-25, 151-52, 174-75, 231-32, 542-43, 1016, 1036)

With respect to another Equity Funding subsidiary, Equity Funding Life Insurance Company of America ("EFLIC"), Secrist made essentially the following allegations: in 1970, EFLIC had embarked on a program of selling totally fictitious life insurance policies to reinsurance companies and one-third of EFLIC's insurance in force was fake; fictitious death certificates were created in order to collect proceeds of these policies from reinsurers; in order to reflect the receipt of premiums, EFLIC had printed its own bank statements, showing false deposits, and counterfeited certificates of deposit; Equity Funding's real assets amounted to $10,000,000 rather than the reported $250,000,000 to $500,000,000; Equity Funding was selling limited partnerships in phony apartment houses; leading Equity officials had sold much of their Equity Funding stock in the previous six months and each had cash and a passport, ready to flee the country at a moment's notice; Equity Funding had connections with the Mafia and would obtain contracts on people's lives if they caused trouble; Haskins & Sells, EFLIC's former auditors, had become suspicious of EFLIC and had dropped the account. (It ultimately turned out,

although Dirks did not know it at the time, that the first three allegations were essentially correct and the remainder false.) (J.A. 53-58, 64, 66-67, 79-80, 152-53, 165, 175-79, 182-83, 205-06, 210, 214, 227, 1212-13, 1240-41)

These allegations were, on their face, improbable because the scheme alleged by Secrist would have required Equity Funding to carry out a massive fraud under the noses of three major accounting firms it had used as auditors, the SEC, the New York Stock Exchange, three or four state insurance commissions that regulated Equity Funding's operations, and various prestigious brokerage firms and banks. (J.A. 283-84)

Dirks nonetheless investigated and discovered that several former and one present Equity Funding employees were inclined to believe some of the allegations made by Secrist, although they had only a little firsthand knowledge and disagreed with some of the allegations. (J.A. 312-14, 365, 411-13, 416-19, 420-22, 424, 427-29, 444, 446-47, 455, 1229, 1230-31, 1319) Dirks confronted Equity Funding's top management with the allegations. The President of Equity Funding emphatically denied the allegations in detail. (J.A. 1225-26) Despite management's denials, Dirks continued his investigation since some people with whom he talked tended to believe some of the allegations.

Dirks also attempted to have the allegations get the same type of publicity that customarily is accorded such rumors within the investment community. Within a few days of his meeting with Secrist, Dirks telephoned *The Wall Street Journal* and was eventually put in touch with William Blundell, a skilled investigative reporter in the *Journal*'s Los Angeles office. Dirks reported to Blundell the allegations about Equity Funding. (J.A. 552-58, 933-35, 1226-27, 1319) Blundell told Dirks that Blundell could

not write a story based on the Secrist allegations because they were "flat out rumors" supported only by hearsay from former employees. (J.A. 941-43) Dirks, however, kept Blundell informed of his investigation on a daily basis and Blundell proceeded to conduct his own investigation, which included talking to Dirks' sources. (J.A. 941-43) Dirks badgered Blundell to write a story, but Blundell refused to do so until after the events involved in this proceeding.

In the meantime, Dirks met with and reported the allegations to Equity Funding's present (Seidman & Seidman) and former auditors (Haskins & Sells), who did nothing. (J.A. 506, 509, 511-13, 562-63, 1233-34) He also spoke with members of the investment community. Dirks initiated some of these conversations in an attempt to determine if the Secrist allegations could have any substance. (J.A. 497-98, 745, 768-71, 1156, 1191) As Dirks' investigation proceeded and rumors circulated throughout the investment community about the allegations of fraud and wrongdoing at Equity Funding, he also took calls from various persons who were seeking to find out what he had heard about Equity Funding. (J.A. 517-20, 578-79, 633, 639, 732-33, 785-95, 1205, 1320) Dirks spoke with anyone who sought to contact him and conveyed the substance of what he had heard, including any information which tended to undercut the allegations. Some of those with whom Dirks spoke sold on the open market, some of them bought, and some of them did not change their positions in Equity Funding stock. (J.A. 573-75, 577-80, 1000-01, 1004, 1012, 1185, 1208, 1237-38, 1320)

Dirks himself did not own or trade any Equity Funding stock. (J.A. 1209)

The President of Equity Funding met on March 23 with two staffers of the New York Stock Exchange, at their

request, to discuss the rumors. After hearing his explanation, the NYSE took no further action. (J.A. 966-67, 1267) As noted, the SEC had been advised of allegations of fraud at Equity Funding as early as 1971, had investigated and had found no basis for proceeding against the company. The SEC was subsequently advised of the allegations at least twice in March 1973—on March 9 by the California Insurance Department and on March 23 in a conversation between Blundell of *The Wall Street Journal* and representatives of the SEC's Division of Enforcement. In each instance the SEC did not act upon the allegations. (J.A. 888-98, 948-50, 1268)

Stanley Sporkin, who was then Deputy Director of the SEC Division of Enforcement and participated in the March 23 conversation, later explained to Congress why he waited nearly a week after Blundell's detailed account to press for the suspension of trading in Equity Funding securities:

> "I just wanted to emphasize what I think the Chairman had mentioned, that we cannot suspend trading merely on the basis of some rumor. We must have more information than that. In this case, in fact, a lot more had been done at that time. The [NYSE] had called Equity Funding in and Mr. Goldblum of the company had denied these rumors. We were really in a quandry on the week of March 26 about what we should do. We had no real verification of the facts." Hearings Before Subcomms. of the Senate Comm. on Appropriations, 93d Cong., 1st Sess. 90 (1973).

At Blundell's suggestion Dirks, along with two former Equity Funding employees, met with the Regional Administrator of the SEC's Los Angeles office on March 27. Dirks spent four days telling the SEC everything he had heard about the allegations of fraud at Equity Funding. (J.A. 566)

Finally, on March 27, in response to the circulating rumors of fraud at Equity Funding, the New York Stock Exchange suspended trading in the company's stock. The SEC suspended trading in Equity Funding stock on March 28, even though the SEC official, after talking with Dirks for two days, was not convinced that the rumors were true. (J.A. 923, 926, 1269-70)

When trading was suspended in Equity Funding stock, the *Journal* still had insufficient evidence on which to write a story and there was no hard evidence that any of the allegations were true. Finally, on March 30, the Illinois Insurance Department discovered that substantial cash assets of Equity Funding, which were supposed to be in a Chicago bank, were missing and officers of Equity Funding refused to sign affidavits swearing that there was no fraud. At this point the California Insurance Department stepped in, using its emergency powers to seize EFLIC, and Blundell then wrote a story in the *Journal* detailing the allegations. (J.A. 565-66, 955-56, 1235-36) On April 5, 1973 Equity Funding filed a bankruptcy petition.

REASONS FOR GRANTING THE WRIT

I. The Decision Of The Court Below Raises Issues Of Great Importance To The Proper Functioning Of The Securities Industry

This cases raises major questions regarding the appropriate role of securities analysts. These are issues of tremendous importance to the investment community, and this case has, accordingly, been the subject of considerable court comment and scholarly debate. *See, e.g.*, *SEC* v. *Lund*, [1981-82] Fed. Sec. L. Rep. (CCH) ¶ 98,428 (C.D. Cal. 1982); Heller, *Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" versus Economic Theory*, 37 Bus. Law. 517 (1982); Langevoort, *Insider Trading and*

the Fiduciary Principle: A Post-Chiarella Restatement, 70 Calif. L. Rev. 1, 30-31 (1982); Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. Legal Stud. 801, 813 (1980); Lorie, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy: A Comment*, 9 J. Legal Stud. 819 (1980); Herman, *Equity Funding, Inside Information, and the Regulators*, 21 U.C.L.A. L. Rev. 1 (1973). Moreover, the decision of the Court of Appeals places severe limits upon what an independent securities analyst may do in the course of investigating and seeking to confirm rumors about past activities, including fraud, at a public corporation without running afoul of the anti-fraud provisions of the federal securities laws. The decision below casts great uncertainty into the work of these professionals and will gravely impair their ability and willingness to investigate allegations of corporate fraud.

The prime function of securities analysts and a major portion of the business of the securities industry involve research, often in-depth research, on companies whose stock is traded in the securities markets. Making that research available to clients or potential clients, either by selling the research or recovering the costs through commissions on stock transactions, is a normal activity of securities firms that is an integral element in the proper functioning of the securities markets.

In conducting his investigation, Dirks was engaging in the normal activities of securities analysts. As even the court below recognized, the important public benefits of these activities cannot be denied. While various regulatory agencies heard the allegations of fraud at Equity Funding over a period of several years, they took no effective action. But within three weeks of Dirks' beginning his investigation, during which time the allegations spread throughout the marketplace, trading in Equity Funding

stock had been suspended and investigations had begun that would confirm the allegations.

The Court of Appeals decision will substantially inhibit these desirable activities of securities analysts. Under the decision, an analyst like Dirks who hears of allegations of fraud has two choices. He can make the allegations public, which as the present case demonstrates, is practically impossible for an analyst who has no control over the regulatory process or the media. In fact, the allegations had been reported to the regulatory agencies, with no results, and the *Journal* refused to print any story on the allegations.

Alternatively, he can remain silent. Indeed, in its oral argument to the Commission the SEC staff explicitly argued that what Dirks should have done with the allegations was "nothing."

Either way, the public is deprived of the benefits of independent investigations because the analyst has no incentive to investigate. Worse yet, any analyst who is foolhardy enough to uncover allegations of fraud will be subject to Section 10b-5 liability if those to whom he repeats the allegations trade with those who do not hear of them.

Such a result is entirely contrary to public policy since it inhibits the reasonable workings of the securities markets and, as in the present case, would discourage the investigation of wrongdoing. Indeed, Judge Wright himself noted:

> "Both the state and the public at large have an interest in exposing corporate misconduct. Ordinarily, we would expect that official law enforcement agencies would be sufficient for that task, but this case shows that the organs of government are not always able to accomplish swift investigation of possible

> crimes. The press also has an historic role in discovering and exposing wrongdoing, but here, too, the press failed to move as quickly as Dirks, who had more immediate financial and reputational incentives to discover the truth about Equity Funding." (App. A-25 to A-26)

The decision below removes those "financial and reputational incentives" by imposing on analysts an obligation, if their research uncovers any evidence of fraud or misconduct, to disclose it publicly (which, as noted, is probably impossible) or face the prospect of a securities fraud charge themselves. This virtually guarantees that neither Dirks nor any other securities professional will invest his time and energy in investigating allegations of corporate fraud. This result is contrary to the common understanding of the role of the securities analyst and contrary to common sense. It is based on the explicit assumption that it is illegal to hope for financial reward for diligent service to the community, an assumption without support in the securities laws. And it raises an issue of significant importance to the securities industry that deserves this Court's attention.

It also conflicts with the decision of this Court in *Chiarella* v. *United States*, 445 U.S. 222 (1980), and creates a conflict with the Second Circuit Court of Appeals, as set forth below.

II. The Decision Of The Court Below Is Inconsistent With This Court's Decision In *Chiarella*, Creates A Conflict In The Circuits, And Violates the Plain Meaning Of The Statute

A. The Decision of the Court Below that Anyone Associated with a Broker-Dealer Automatically Owes a Fiduciary Duty to the Public and the SEC Is an Unprecedented and Unsupported Effort to Circumvent *Chiarella*.

The court below found that petitioner violated Section 10(b), Rule 10b-5 and Section 17(a) because, as an employee of a registered broker-dealer, he "breached his duty to the Commission and to the public not to misuse insider information." (App. C-1) This novel holding of the Court of Appeals is completely contrary to this Court's decision in *Chiarella* v. *United States*, 445 U.S. 222 (1980), and imposes on broker-dealers and other securities professionals an unwarranted public duty that will work to constrain them in performing their jobs.

In *Chiarella*, this Court held that liability under Section 10(b) and Rule 10b-5 for failing to disclose material information presupposes a legally recognized fiduciary duty to make such disclosure. This Court stated that:

> "One who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.'" 445 U.S. at 228, quoting *Restatement (Second) of Torts* § 551(2)(a) (1976).

This Court held that such a duty arises only out of the relationship between the party in possession of the material information and the other party to the stock transaction. 445 U.S. at 232. This Court rejected the principle that "[t]he use by anyone of material information not generally available is fraudulent." *Id.*

The court below, however, found that persons associated with registered broker-dealers owe a fiduciary duty to the world. No such general duty to the public has ever before been imposed on those associated with registered broker-dealers. Although the court below purported to be affirming a conclusion of the Commission, the Commission never found that petitioner owed or breached any

duty to the public or to the Commission. Such a position was never urged upon the Commission by the Division of Enforcement and the Commission itself did not take such a position in its decision or before the Court of Appeals.

Judge Wright concluded that a general duty to the Commission and the public at large can be implied because broker-dealers are obligated to meet a high ethical standard which "restrains broker-dealers not only in their dealings with their customers, but also in their dealings with the SEC and the public at large." (App. A-29) Judge Wright found this ethical duty, in turn, in the statement by this Court, in *United States* v. *Naftalin*, 441 U.S. 768 (1979), that an objective of the securities laws is to achieve a high standard of ethics "in every facet of the securities industry," *id.* at 775. (App. A-28) Judge Wright cited as further support for his conclusion the fact that the Securities Exchange Act of 1934 imposes on broker-dealers "myriad duties not imposed on corporate officers or other members of the general public." (App. A-27)[3] And Judge Wright also cited the legislative history of the securities laws for the proposition that they were designed to prevent the sale to the public of unsound or worthless securities. (App. A-30)

From these general statements of legislative intent about ethical behavior in the securities industry, and nothing more, Judge Wright has conjured up a fiduciary

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[3] But Judge Wright nowhere found in that scheme of regulation any express duty of disclosure owed by broker-dealers to the public or the SEC. And, indeed, there is no such duty. As Judge Wright conceded, "the main focus of the SEC's regulation of broker-dealers has been to ensure that broker-dealers treat their customers honestly and fairly." (App. A-28)

duty owed by broker-dealers and their employees to all members of the public, including purchasers on the open market with whom neither the employees nor the seller have any relationship. This decision has enormous potential ramifications for broker-dealers, as well as for the rest of those professionals (such as lawyers and accountants) "in every facet of the securities industry" who are held to "high ethical standards." Judge Wright's rationale implies that all such professionals, because they should behave ethically, can automatically be held liable for securities fraud whenever their failure to disclose material non-public information to the public results in "unsound" or "fraudulent" securities being sold. (App. A-30 to A-31) Presumably such professionals could be subjected to private actions for damages under Rule 10b-5, as well as to SEC disciplinary proceedings.

In the guise of finding a duty under *Chiarella*, Judge Wright has effectively eviscerated that decision. This Court should make it clear that "ethical" obligations, if they exist, are not *ipso facto* converted into fiduciary duties, and that the antifraud provisions of the securities laws will not be used as a means of enforcing such "ethics." As this Court said in *Chiarella*, "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud." 445 U.S. at 234-35. The decision of the court below imposes upon securities professionals unbounded duties to the public and to the SEC that unfairly and unwisely subjects them to liability under the securities laws and interferes with the performance of important activities beneficial to the public and to the open market.

B. The Decision of the Court Below that the Recipient of Information from Corporate Insiders May Inherit the Insiders' Fiduciary Duties to Shareholders or Purchasers, Even if the Insiders Breached No Duties in Disclosing Such Information, Is Contrary to *Chiarella* and Creates a Conflict Within the Circuits

Judge Wright's opinion states that the *Chiarella* requirements were met in this case because, in addition to a duty to the public and to the SEC, Dirks "became subject to his informants' disclose-or-refrain obligation." (App. A-25) Even if the two-judge Court of Appeals' judgment intended—which is far from clear[4]—to affirm the Commission's finding that Dirks was a "tippee" of corporate insiders, and thus inherited a fiduciary duty to Equity Funding shareholders, the decision is incorrect, inconsistent with *Chiarella* and sound public policy, and in direct conflict with a decision of the Second Circuit Court of Appeals.

In *Chiarella*, this Court held that in a nondisclosure case "there can be no fraud [under Rule 10b-5] absent a duty to speak" arising from "a fiduciary or similar relation of trust and confidence." 445 U.S. at 228, 235. This Court also stated that an outsider's liability for disseminating "inside information" has been viewed "as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty." 445 U.S. at 230 n.12.

In this case, Dirks was a stranger to, and did not have a fiduciary relationship with, any purchasers of Equity

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[4] The March 29, 1982 three-paragraph judgment, in which Judge Robb joined Judge Wright, specifically upheld the SEC decision on the basis that petitioner "breached his duty to the Commission and to the public," but does not refer to breach of a duty inherited from corporate insiders. (App. C-1) That discussion appears only in Judge Wright's opinion, in which Judge Robb did not join.

Funding securities. Dirks was not an Equity Funding officer, director or employee. He did not own, purchase or sell Equity Funding stock and he was not involved as broker or agent in any sale. Furthermore, Dirks obtained information about Equity Funding *not* through an insider's breach of a fiduciary duty and *not* through any unethical or unlawful activities, but through the efforts of former employees to expose a fraud and in the normal course of a securities analyst's activities.[5] The SEC conceded that Dirks' sources had not breached any fiduciary duty in talking to Dirks. (SEC Court of Appeals Brief at 30.) Likewise, Judge Wright assumed that Dirks' sources breached no fiduciary duty in making their revelations. (App. A-23) Indeed, no one has ever suggested that Dirks acted unlawfully or unethically in obtaining information about Equity Funding.

In attempting to satisfy the *Chiarella* requirements, the Commission—and Judge Wright—relied, instead, upon the theory that even if Dirks himself owed no direct fiduciary duty and even if his informants had not breached any fiduciary duty nevertheless he was a "tippee" of Equity Funding corporate insiders and automatically acquired a duty to "disclose or refrain" by receiving confidential corporate information from the "insiders." (App. B-13; App. A-24 to A-25) The Commission held that the mere possession of "confidential" corporate information by one who knows that it came from inside the corporation results in an obligation to disclose that information or refrain from trading on it. (App. B-13)

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[5] In fact, under the law of California, where Equity Funding was headquartered, these employees had a duty to expose fraud or face possible criminal liability. Cal. Corp. Code § 3019 (1955), now renumbered with technical emendations, as Cal. Corp. Code § 2254 (1977).

It is true that one who receives certain types of nonpublic information may acquire a duty to disclose or refrain from trading. But it is not the receipt of *all* nonpublic corporate information that gives rise to this duty. This Court in *Chiarella* rejected the principle that "[t]he use by anyone of material information not generally available is fraudulent," requiring instead proof of "a relationship . . . that could give rise to a duty" to disclose. 445 U.S. at 232. Such a duty arises only if the person from whom the "tippee" received the information breached his own fiduciary duty in conveying it. 445 U.S. at 230 n.12.

Despite this Court's decision in *Chiarella*, Judge Wright stated that a breach of fiduciary duty by the Equity Funding insiders was not necessary in order for Dirks to acquire their fiduciary duty not to trade on the information. (App. A-24) This theory, which is essentially that adopted by the Commission, has been called by one commentator "a novel application of fiduciary attribution principles." Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 Cal. L. Rev. 1, 30 (1982).

Judge Wright's theory is also sharply at odds with what appears to be the only other post-*Chiarella* decision on this question to date. In *Walton* v. *Morgan Stanley & Co., Inc.*, 623 F.2d 796 (2d Cir. 1980), the Second Circuit Court of Appeals held that an investment banking firm did not acquire or breach any *Chiarella*-type fiduciary duty to a corporation when it traded in the corporation's stock on the basis of confidential earnings reports it acquired from the corporation while investigating it for a client. *Id.* at 798-99. Although the company's executives had a duty not to trade on the basis of such information, they did not breach any fiduciary duty by disclosing the information to the investment banking firm. The invest-

ment banking firm knew, however, that the information was confidential corporate data that came from inside the company, and had specifically been asked to keep it so. Nonetheless, the court did not find that the investment bankers acquired any duty to disclose or refrain from trading on this information when they received it legitimately. *Id.* at 799.

To the extent that the judgment of the Court of Appeals affirms the view of the Commission that the simple receipt of nonpublic information conferred on Dirks a duty to disclose, it is contrary to *Chiarella* and in conflict with *Walton*. This Court should eliminate that conflict and make it clear that a noninsider recipient of material nonpublic information does not violate Rule 10b-5, unless he is a participant after the fact in a breach of a duty of confidentiality owed by an insider.

C. The Finding of the Court Below that Unverified Rumors Are "Material Facts" Is Incorrect and Will Interfere with the Work of Analysts

Until this case, the courts have uniformly held, as the explicit language of the statutes requires, that Section 10(b), Rule 10b-5, and Section 17(a) apply only to misstatements or omissions of "material fact," *TSC Industries, Inc.* v *Northway, Inc.*, 426 U.S. 438 (1976), and not to rumors, allegations, and other unverified information. For example, in *Financial Industrial Fund, Inc.* v. *McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973), the court held that before a duty to disclose information arises, "the contents must be verified sufficiently to permit . . . [those involved] to have full confidence in their accuracy." 474 F.2d at 519.[6]

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[6] *Accord, Hassig* v. *Pearson*, 565 F.2d 644 (10th Cir. 1977); *Marx & Co.* v. *The Diner's Club, Inc.*, 550 F.2d 505 (2d Cir.), *cert. denied*, 434

Judge Wright admitted that the allegations Dirks heard did not come "from a source whose word would not be doubted." (App. A-34) Yet the Court of Appeals affirmed the Commission's finding that the information disseminated by Dirks consisted of "material facts."

What Dirks disclosed were not "facts" in any known sense of the word. The allegations that Dirks heard were unverified and widely doubted in the investment community. That the allegations were never considered as "fact" is confirmed by the reactions of everyone who heard them, from Dirks or otherwise. Although some sold their Equity Funding stock, others either did nothing or actually purchased additional Equity Funding stock.[7] In addition, the various regulatory agencies charged with investigating and reporting corporate wrongdoing, including the SEC and various state insurance departments, heard the same allegations as Dirks but did not

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U.S. 861 (1977); *Mitchell* v. *Texas Gulf Sulphur Co.*, 446 F.2d 90, 94 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); *Alaska Interstate Co.* v. *McMillan*, 402 F. Supp. 532 (D. Del. 1975).

[7] The difference between this case and a true "fact" case like *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), or *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969), is obvious. When one of Curtiss-Wright's directors in *Cady, Roberts* tipped people about the company's falling dividend, no one bought the stock. They knew what he said was reliable and what it meant. When Texas Gulf insiders tipped people about mineral finds, no one sold the stock. Again, they knew the information was reliable and what it meant. In contrast, the reaction of the investment community, as well as regulatory agencies, in the present case makes it clear that the Secrist allegations, which were denied by Equity Funding management, were simply not "facts."

take any action on them. As Stanley Sporkin, then Deputy Director of the SEC Division of Enforcement, testified before Congress: "We were really in a quandry on the week of March 26 about what we should do. We had no real verification of the facts." Hearings Before Subcomms. of the Senate Comm. on Appropriations, 93d Cong., 1st Sess. 90 (1973).

Moreover, while it was ultimately shown, once hard evidence was uncovered, that some of the allegations heard by Dirks were true, it was also ultimately shown that other allegations, each of which initially was as plausible and as supported as the true allegations, were in fact false.[8] Indeed, in two reported cases dealing with some of the same Equity Funding allegations heard by Dirks, two courts have held that many of the same allegations were rumors, not facts, and that there was no obligation to disclose them. *See Pachter* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.* 444 F. Supp. 417, 422 (E.D.N.Y.), *aff'd mem.*, 594 F.2d 852 (2d Cir. 1978); *Wiener* v. *Oppenheimer & Co.*, [1979] Fed. Sec. L. Rep. (CCH) ¶ 96,764, at 95,001 (S.D.N.Y. 1979).

Judge Wright's opinion thus flies in the face of the explicit statutory language and prior case law. Moreover, the decision of the court below strikes a direct blow at the research function of the securities analyst. Judge Wright

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[8] Of the eight allegations made by Ronald Secrist on March 7, only three—relating to the creation by Equity Funding of fictitious insurance policies and certificates of deposit—turned out to be true. The remaining allegations, which were false, included allegations that Equity Funding only had $10,000,000 in assets; that it had fictitious real estate on its books and was selling it through limited partnerships; and that Haskins & Sells had refused to continue as auditor for EFLIC.

recognized the important role that securities analysts play in promoting efficient capital markets. (App. A-30) He did not question that Dirks' investigation was nothing more than a vigorous example of the type of research that goes on all the time. Indeed, in the present case Dirks was doing what securities analysts do every day—conducting research, talking to company officials and talking to outside experts in the industry.

Judge Wright seems to believe, however, that the right of the analyst to promote his research ends when "business ethics" suggest that the analyst make public disclosure of his findings even if what he finds is not "fact." (App. A-30) Such an obligation of public disclosure of an analyst's research efforts will impose highly uncertain new duties upon professional securities analysts. Any time an analyst uncovers or develops negative allegations or rumors on a company, the dissemination of those allegations may cause some of those who hear them to credit the allegations and to sell. If it turns out that those allegations are well founded, or even if they are not but their effect is that the stock is worth less than the price at which it was sold, it can be expected that the purchasers will turn around and sue the analyst under Rule 10b-5 for aiding and abetting the sale of an "unsound" or "fraudulent" security. That will simply assure that analysts do not undertake investigations like Dirks did here.

But for Dirks' efforts the fraud at Equity Funding might have remained uncovered for years. Indeed, Stanley Goldblum, Equity Funding's president who served a jail term for his part in the fraud, was of that view and blamed Dirks for exposing the fraud. As Dean Lorie of the University of Chicago stated: "We should see to it that the Raymond Dirkses of the future get gold medals rather than censure and other punishment." Lorie, *In-*

sider Trading: Rule 10b-5, Disclosure, and Corporate Privacy: A Comment, 9 J. Legal Stud. 819, 822 (1980). By wrongly holding that unverified allegations are "material fact" the court below has managed to achieve just the opposite result.

CONCLUSION

For the foregoing reasons, the Petition for a Writ of Certiorari should be granted.

Respectfully submitted

DAVID BONDERMAN
Counsel of Record
LAWRENCE A. SCHNEIDER
ERIC SUMMERGRAD
ARNOLD & PORTER
1200 New Hampshire Ave., N.W.
Washington, D.C. 20036
(202) 872-6700
Attorneys for Petitioner
Raymond L. Dirks

August 17, 1982

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 81-1243

RAYMOND L. DIRKS, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION, RESPONDENT

Petition for Review of an Order of the
Securities and Exchange Commission

Argued January 7, 1982

Opinion Filed May 18, 1982 *

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* A judgment in this case, Judge Tamm dissenting, issued on March 29, 1982, which reads in material part as follows:

> The record in this case fully supports the Commission's findings that petitioner breached his duty to the Commission and to the public not to misuse insider information and that he was compensated for so doing. The record also assures us that the other findings of the Commission are not clearly erroneous and that the Commission's conclusions are solidly based in the law.

David Bonderman, with whom *Lawrence A. Schneider* and *David Hird* were on the brief, for petitioner.

Michael K. Wolensky, Associate General Counsel, Securities and Exchange Commission, with whom *John P. Sweeney*, Assistant General Counsel, *Paul Gonson*, Solicitor, and *Andrew W. Sidman*, Attorney, Securities and Exchange Commission, were on the brief, for respondent.

Before WRIGHT, TAMM, and ROBB, *Circuit Judges*.

Opinion filed by *Circuit Judge* WRIGHT.

Circuit Judge ROBB concurs in the result.

Circuit Judge TAMM dissents.

WRIGHT, *Circuit Judge*: This case requires us to review the Securities and Exchange Commission's interpretation of its Rule 10b-5 in light of the Supreme Court's most recent discussion of Rule 10b-5 and the statutory provisions upon which it rests. The Commission (SEC) has censured petitioner Raymond Dirks, vice president in a broker-dealer firm, for aiding and abetting violations of Rule 10b-5 by repeating information he had learned from former employees of a corporation to investors likely to sell their shares of the corporation's stock to members of the public without access to the same information. Dirks asks this court to reject the SEC's interpretation of Rule 10b-5 on the authority of *Chiarella v. United States*, 445 U.S. 222 (1980), claiming that the Supreme Court's analysis in that case forbids the SEC to punish him under Rule 10b-5 for what he did.

We have before us both sensational facts and difficult issues of law and policy.[1] The information Dirks passed

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[1] This case has also spawned a fair amount of commentary. *See, e.g.*, Heller, Chiarella, *SEC Rule 14e-3, and* Dirks: *Fairness versus Economic Theory*, 37 BUS. LAW. 517 (1982); Herman, *Equity Funding, Inside Information, and the Regu-*

on to his clients was no mere "tip": in two weeks of concerted effort, at times resembling something from detective fiction, Dirks investigated and confirmed rumors of massive fraud by the Equity Funding Corporation of America (Equity Funding),[2] an insurance holding company whose stock traded on the New York Stock Exchange. Largely thanks to Dirks one of the most infamous frauds in recent memory was uncovered and exposed, while the record shows that the SEC repeatedly missed opportunities to investigate Equity Funding.

The issues of law and policy concern the role of private securities analysts who investigate corporate frauds. Securities analysts can be an important source of information for the public, supplementing an often overtaxed SEC enforcement staff and the press. There is some danger that the threat of liability under Rule 10b-5 may dampen the zeal of analysts in ferreting out the truth about corporate practices.

We recognize that concern, but we also recognize its limits. Private analysts may not keep information they have discovered from the SEC, while their clients dump fraudulent securities on an uninformed public. In this case, we defer to the SEC's judgment about what will best serve the long-range interests of the public and accomplish the statutory purposes behind Rule 10b-5. Therefore, we reject Dirks' argument based on *Chiarella* as well as several other challenges he presents.

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lators, 21 U.C.L.A. L. REV. 1 (1973); Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 CALIF. L. REV. 1, 30-33 (1982).

[2] Most of the fraud actually occurred in two insurance companies controlled by Equity Funding Corporation of America: Equity Funding Life Insurance Corporation and Bankers National Life Insurance Company. This opinion does not distinguish among the two subsidiaries and their parent; all three are identified solely as "Equity Funding."

I

Because the SEC has chosen merely to censure Dirks, and has not taken any other action against him in connection with this case, we need not consider whether all of Dirks' actions discussed by the SEC and the administrative law judge who first heard the case violated Rule 10b-5. A single willful violation of Rule 10b-5 or the statutes upon which it is based provides the SEC with discretion to impose the lightest administrative penalty available to it. *See* 15 U.S.C. § 78*o*(b)(D) (1976). Therefore, we confine our recitation of the facts to Dirks' least ambiguous actions.

The critical events in this case occurred in March 1973. During that period Raymond Dirks was an officer of Delafield Childs, Inc., a registered broker-dealer that served a clientele composed primarily of institutional investors. Dirks himself specialized in providing investment advice about the insurance industry, and he was apparently highly respected within the investment community for his knowledge of insurance companies and his willingness to go beyond mere financial data in evaluating investments.

Dirks regularly provided investment advice to a number of institutions that he knew had invested or might be interested in investing in insurance company stocks. As far as the record shows, he had no formal relationship with these institutions; he simply tried to be aware of their investment objectives and strategies, and to inform them whenever he developed information that he thought would be of interest to them. Under the custom of the industry, Dirks received no direct compensation from these clients. Rather, if they thought the information Dirks gave them was valuable, they would direct some of their brokerage business through Delafield Childs, thus giving Dirks' firm a chance to earn brokerage commissions.[3]

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[3] *See* Joint Appendix (JA) 640-644 (testimony of R. Dirks before hearing examiner).

On March 6, 1973 Dirks received a telephone call from Ronald Secrist, who had recently been fired from his job with Bankers National, a New Jersey life insurance company that had been acquired by Equity Funding four years earlier. Secrist told Dirks that he had information about fraud and illegality at Equity Funding, and the two men arranged a meeting for the next day.

Dirks and Secrist met for several hours on March 7. Secrist made a series of detailed but nearly incredible allegations about Equity Funding: mainly that one of its subsidiaries had created false insurance policies and records to inflate its sales figures, but also that it was selling partnerships in nonexistent real estate, that its top officers had Mafia connections which they used to threaten the lives of employees who objected to the fabrications, and that the accounting firm of Haskins & Sells had dropped the Equity Funding account out of disagreement with the company's business practices. Although Secrist had neither personal knowledge nor documentation to support any of his charges, Dirks developed a hunch that Secrist was not merely a vindictive former employee trying to get back at the people who fired him. Therefore, Dirks decided to investigate Secrist's allegations.

Dirks' investigation had three major phases, the first two of which are not very important to the issues in this appeal. He began by examining publicly available data on Equity Funding's insurance sales. He compared Equity Funding's ratio of sales to sales force with that of its competitors, but he decided that the figures neither confirmed nor refuted the possibility that Equity Funding was fabricating insurance policies. Second, he contacted other people in the investment community who followed Equity Funding stock—many of them because they had invested in it—to see if they knew anything that could prove or disprove the rumors. This inquiry, too, was generally fruitless; most of the people with

whom Dirks spoke did not believe there was any truth in Secrist's story. Through one informant Dirks did learn that Secrist's allegations about Haskins & Sells were untrue. The accounting firm had lost Equity Funding's business to a competitor and would be glad to get it back.

Nevertheless, Dirks continued to talk to Secrist regularly, and he continued to suspect that some of Secrist's charges might be justified. Dirks also telephoned Equity Funding's chairman, Stanley Goldblum, who denied that there was any fraud at Equity Funding and invited Dirks to visit the company's headquarters in Los Angeles.

Dirks flew to Los Angeles on March 19 to begin the third phase of his investigation. He spent most of the day on March 20 with Patrick Hopper, a former vice president of Equity Funding who had retired to live the life of a wealthy beach bum. Hopper had been Secrist's superior for a time at Banker's National, and it was Hopper who had suggested to Secrist that he tell his story to Dirks after Secrist lost his job. Hopper told Dirks that Secrist tended to exaggerate things, but that he—Hopper—tended to believe the gist of Secrist's allegations about phony insurance. In 1971 Hopper had been following Equity Funding's life insurance sales on a week-by-week basis until late October, when the company stopped circulating weekly reports. When the final figures for that year appeared in early January, Hopper had noted that the final figure for life insurance sales was almost double what his running total had been in October. He also saw the sales figures for what had previously been the best of the company's five sales districts, and they were far less than a fifth of the total insurance sales figures for 1971.

Hopper also reported that he had attended a dinner in New York with several other Equity Funding officers, and that some of them had joked openly at the table about "the Y business"—according to Secrist, the euphe-

mism by which the insurance fabrication program was known within the company. Beyond that, Hopper had no direct knowledge of fraud at Equity Funding. But on the afternoon of March 20, he and Dirks sought out another former Equity Funding employee, Frank Majerus, who Hopper suspected might know something concrete. After a great deal of coaxing, Majerus admitted that he had been involved in altering the company's insurance-in-force figures for 1970.

Dirks spent much of the next day, March 21, with the top management of Equity Funding. The company's officers continued to deny, and even to ridicule, the notion that there was anything amiss at Equity Funding. But over the next two days Dirks contacted four other men whose names had been given him by Hopper and Secrist. Two had worked as computer technicians for Equity Funding, one had worked for the company that programmed Equity Funding's computers, and one was still employed at Equity Funding. All four had independently come to the conclusion that the company's computer files contained large blocks of phony policies. The current employee, Donald Goff, had heard talk about phony insurance and seen figures for insurance-in-force for the years 1970-1972 that did not correspond to the figures ultimately announced by the company.

Throughout his investigation Dirks had been in contact with a number of investors and analysts—some because he hoped they might give him information or support, others because they were clients or potential clients and his records showed they were interested in information about Equity Funding, and still others simply because, having heard rumors about his investigation, they called him. On all occasions Dirks candidly discussed the status of his investigation with anyone who asked.

From Friday, March 23, through Monday, March 26, Dirks spoke repeatedly with members of the investment community. As events developed, these were the last

two full days on which it was possible to buy or sell Equity Funding stocks on the New York Stock Exchange. During this period Dirks followed his prior practice of calling companies that he knew were interested in news about Equity Funding and returning calls from anyone else who tried to contact him. At one point, on March 26, Dirks telephoned a non-client, Loew's Inc., because he had heard that it had just purchased a large block of Equity Funding stock from one of his clients, and he wanted to make sure Loew's was aware of his doubts concerning the company. Unsurprisingly, the record shows that many of those with whom Dirks spoke on or after March 20—by which time he had substantiated the key portions of Secrist's allegations—sold their Equity Funding securities as quickly as possible. They succeeded in unburdening themselves of approximately $15.5 million in Equity Funding stock and $1 million in convertible debentures by the time the New York Stock Exchange finally halted trading in Equity Funding securities.[4]

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[4] *See* JA 1064. Dirks spent several hours on the telephone with officers of The Boston Company Institutional Investors, Inc., on March 20, at one point putting Hopper on the line to repeat what he had told Dirks and to discuss Equity Funding with The Boston Company officers. The next day, The Boston Company sold all of its Equity Funding stock for over $7 million and all of its holdings of Equity Funding debentures for $575,000. *See In the Matter of The Boston Company Institutional Investors, Inc.*, Initial Decision at 42 (Sept. 1, 1978), JA 1177 (hereinafter cited as Initial Decision). Dirks spoke with officers of the Dreyfus Corporation on March 23; at the opening of business on March 26 Dreyfus sold its holdings of Equity Funding debentures. *Id.* at 59-60, JA 1194-1195. On March 26 Dirks spoke with representatives of John W. Bristol & Co., Tomlin, Zimmerman & Parmalee, Inc., and Manning & Napier (which was not a regular client of Dirks'). By the close of business on that day all three had sold all or substantially all of their Equity Funding stock and debentures. *See id.* at 50, 63, 73, JA 1185, 1198, 1208. John W. Bristol & Co. alone sold more than $8 million worth of securities on March 26.

It is not clear how many of those with whom Dirks spoke promised to direct some brokerage business through Delafield Childs to compensate Dirks, or how many actually did so. But it is clear that the custom of the industry provided that Dirks' regular clients would compensate him in that manner. The record shows that some of those with whom Dirks spoke during this period discussed the idea of directing business through Delafield Childs and did in fact use Delafield Childs as a broker for securities transactions during the ensuing weeks.[5]

Meanwhile, during the entire week that Dirks was in Los Angeles investigating Equity Funding, he was also in touch regularly with William Blundell, the *Wall Street Journal*'s Los Angeles bureau chief. Dirks kept Blundell up to date on the progress of the investigation and badgered him to write a story for the *Wall Street Journal* on the allegations of fraud at Equity Funding. Blundell, however, was afraid that publishing such damaging rumors supported only by hearsay from former employees might be libelous, so he declined to write the story. Nevertheless, on March 26 Blundell contacted the SEC's Los Angeles office and repeated what Dirks had told him over the course of the previous week. The SEC took no immediate action.[6] Blundell then arranged a

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[5] Dirks was told explicitly by representatives of The Boston Company that they would direct $20,000 of commission business through Delafield Childs. *See* JA 323; Initial Decision, *supra* note 4, at 45 (JA 1208). In addition, earlier in Dirks' investigation, The Boston Company arranged to give Delafield Childs approximately $4,000 of brokerage commissions in return for "[i]nsurance co. report & recommendation." JA 1062.

[6] The SEC had a history of failing to act promptly in the Equity Funding case. In 1971, the SEC was approached by William Mercado, an Equity Funding employee, with reports of questionable accounting practices at Equity Funding. The SEC performed a cursory investigation and took no further action. *See* JA 1080A-1097. When Ronald Secrist decided to discuss his suspicions about false insurance with someone, he

meeting for the next day, to include Dirks, Hopper, and the SEC staff in Los Angeles.

Thus, Dirks presented what he knew about Equity Funding to the SEC staff beginning on Tuesday, March 27, and continuing through the next day. The SEC took no action against Equity Funding on Tuesday, but late that day the New York Stock Exchange halted trading in Equity Funding stock after the Salomon Brothers firm lodged a complaint of "disorderliness" in the market for the stock. In less than two weeks—while Dirks was pursuing his investigation and spreading word of Secrist's charges—the trading price of Equity Funding shares had fallen from $26 to less than $15; the price had fallen more than $3 since the market opened on March 26.[7]

On Wednesday, March 28, the *Wall Street Journal* printed an Equity Funding press release denying

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did not go to the SEC because he had heard that the SEC had repeated information it received from employees to Equity Funding's president. *See* JA 223.

On March 7, 1973, however, before meeting with Dirks, Secrist told his whole story to people at the New York State Insurance Commissioner's Office. They in turn relayed the information to the California Insurance Department, which had jurisdiction over Equity Funding. On March 9, 1973, an official of the California Department had a conference with one of the staff attorneys in the SEC's Los Angeles office at which he repeated Secrist's charges as relayed by the New York authorities. The California official stated that he thought his department might want to do a full inspection of Equity Funding, and he asked for help from the SEC. The SEC staff attorney stated that similar allegations had been made about Equity Funding before by disgruntled employees. He recommended "delaying any type of inspection of the Equity Funding operations until next year when more personnel are available." JA 888-898, 1072-1073. The attorney's memorandum to his superior describing this conversation was apparently not written until March 16, and it was not read until after the SEC's interviews with Dirks had begun.

[7] *See* Herman, *supra* note 1, at 1-4 & n.3.

"rumors circulating in the financial community about the accuracy of statements by its life insurance subsidiary." That afternoon, while the Los Angeles staff was still closeted with Dirks, the SEC suspended trading in Equity Funding securities for ten days. Later that week, the Illinois and California insurance departments staged surprise inspections of Equity Funding. California impounded Equity Funding's corporate records, and Illinois investigators discovered that $20 million in corporate bonds supposedly owned by Equity Funding—approximately 70 percent of the assets of its major subsidiary—simply did not exist.[8]

On April 2, the SEC filed a complaint against Equity Funding, and the *Wall Street Journal* published a front-page story written by Blundell but based largely on information assembled by Dirks. Equity Funding immediately went into receivership. Blundell was nominated for a Pulitzer Prize for his coverage of the Equity Funding scandal[9]; Dirks became the object of the disciplinary proceeding on review in this case.

The SEC's disciplinary proceeding originally included not only Dirks but also five of his institutional clients who sold Equity Funding stock between March 12 and March 27. After lengthy hearings, an administrative law judge found that four of the clients and Dirks had violated Rule 10b-5 by trading on the basis of—or in Dirks' case, communicating—inside information. The administrative law judge imposed a censure on each of the four institutions and suspended Dirks from association with

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[8] Blundell, *A Scandal Unfolds: Some Assets Missing, Insurance Called Bogus at Equity Funding Life*, WALL ST. J., Apr. 2, 1973, at 1, col. 6, 14, col. 1.

[9] *See* Initial Decision, *supra* note 4, at 105 (JA 1240). In addition to the article cited in note 8 *supra*, the *Journal* printed several other stories about Equity Funding in the first weeks of April 1973. Herman, *supra* note 1, at 1 n.2, provides a brief bibliography of press coverage of the Equity Funding scandal.

any registered broker or dealer for 60 days.[10] The institutions did not appeal their censures to the Commission, but both Dirks and the SEC's Enforcement Division appealed—Dirks claiming that there was insufficient factual and legal basis for finding that he had violated Rule 10b-5, and the Enforcement Division seeking imposition of a more lengthy suspension.

The SEC rendered its decision on January 23, 1981. It concluded

> Dirks came into the possession of material, nonpublic corporate information, from persons he knew were insiders, at a time when he knew that the information was confidential and not then publicly available. He communicated that information to those likely to trade before the information became generally available. In committing these acts, Dirks acted with scienter. Accordingly, we conclude that Dirks willfully aided and abetted violations by [his institutional clients] of Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder.

JA 1329. However, the SEC reduced the sanction imposed on Dirks to a mere censure, in order not to "hamper legitimate, investigative securities analysis" and in order to recognize Dirks' role in bringing the Equity Funding scandal to light and his theretofore unblemished record in the investment community. *See* JA 1330.

Dirks submitted a petition for review to this court pursuant to 15 U.S.C. § 78y(a) (1976).

II

Section 15(b) of the Securities Exchange Act authorizes the SEC to impose censures or other penalties on persons associated with registered broker-dealers if the person involved

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[10] Initial Decision, *supra* note 4, at 178 (JA 1313).

> has willfully violated any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, this chapter [the Securities Exchange Act of 1934], [or] the rules or regulations under any of such statutes * * *.

15 U.S.C. § 78*o*(b)(4)(D) (1976). The three provisions upon which the SEC rested its decision, *see* page 12 *supra*, overlap to a large extent; of these, Rule 10b-5 is the most inclusive.[11] It states:

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[11] Section 17(a) of the Securities Act of 1933 provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a) (1976).

Section 10(b) of the Securities Exchange Act of 1934 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may

> It shall be unlawful for any person, directly or indirectly, * * *
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1981). The essence of the SEC's position, and the legal basis for its censure, is that Dirks and his clients had a duty under subsection (c)[12] to disclose the material information they possessed or refrain from trading Equity Funding securities as long as the information had not been disseminated to the public.

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prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id. § 78j(b).

Rule 10b-5 is an obvious amalgamation of the two statutory provisions. It was adopted in 1942 to extend the protections of § 17(a) to sellers of securities as well as purchasers of securities. *See* R. JENNINGS & H. MARSH, SECURITIES REGULATION 855 (4th ed. 1977). Jennings and Marsh state, "[T]he Rule covers the waterfront so far as securities transactions are concerned." *Id.* at 856.

[12] The duty to disclose-or-refrain is traditionally considered to be based on subsection (c), but simple failure to disclose material facts might conceivably come under subsection (a) as well. Courts have never distinguished completely among the subsections of Rule 10b-5, and the different subsections do not carry different legal consequences. *See Chiarella v. United States*, 445 U.S. 222, 225 n.5 (1980); *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

The concept of a duty to "disclose-or-refrain" under Rule 10b-5 originated in the SEC's benchmark decision in *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). There the SEC held that a registered broker-dealer violated Rule 10b-5 by selling stock in Curtiss-Wright Corporation based on information that the broker-dealer firm received from one of its partners who was also a director of Curtiss-Wright. Corporate "insiders," such as the director, were bound not to take advantage of information "intended to be available only for a corporate purpose and not for the benefit of anyone" when they knew it was unavailable to those with whom they dealt. 40 S.E.C. at 912. Subsequent cases settled that, even if the insiders themselves did not trade, they were forbidden even to communicate nonpublic "inside information" to others who were likely to trade before the information became public, *see SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), and that Rule 10b-5 required those who received inside information from insiders to disclose it or refrain from trading, *see Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*, 495 F.2d 228 (2d Cir. 1974); *Investors Management, Inc.*, 44 S.E.C. 633 (1971).

In other circumstances, the Supreme Court extended the duty to disclose or refrain to people who were not traditional insiders, in that they had no special access to information about the assets or plans of the corporations that issued the securities in which they traded. *See Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), which involved bank employees who purchased shares in a tribal trust fund from mixed-blood Ute Indians without disclosing that there was a secondary market for the shares, at higher prices, among non-Indians, and *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), which involved an investment adviser who purchased stock for his own account just before publishing a recommendation that his clients buy the stock. These cases became known as "market infor-

mation" (as opposed to inside information) cases, because the information at issue related solely to the market for the securities rather than their intrinsic value. *See generally* Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798 (1973).

The foregoing cases do not always make clear, however, what circumstances trigger a duty to disclose or refrain from trading. Variants of two general theories appear, often within the same opinion.[13] On the one hand, some of the language in the cases finds the element of unfairness and fraud in conflicts of interest on the part of traders or their informants who profit at the expense or to the exclusion of those who have placed trust in them. The conflict of interest may arise from a traditional fiduciary relationship, as between a corporate director and the corporation's shareholders, or a similar relationship of trust, as between employers and employees or investment bankers and their clients. On the other hand, some of the cases imply that the securities laws impose a duty to disclose or refrain from trading based on the nature of the undisclosed information. The theory is that all investors should have equal access to information that a reasonable investor would consider material to investment decisions, and that any trade in which only one party had an opportunity to learn and did learn such information is inherently unfair.[14]

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[13] *See, e.g., SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 851-852 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

[14] Tension between the "information" theory and the "fiduciary" theory is hardly new. It appears clearly in the Supreme Court's seminal case on securities fraud, *Strong v. Repide*, 213 U.S. 419 (1909), which antedated the basic federal securities statutes by 25 years and *Cady, Roberts* by over half a century. In *Strong*, the Court held that a corporate director and controlling shareholder could be liable for purchasing a minority shareholder's interest without disclosing that he was about to sell the corporation's assets to a third

The Supreme Court has recently sought to resolve the tension between the "fiduciary" theory and the "information" theory of Rule 10b-5's disclose-or-refrain prescription. *Chiarella v. United States* involved an employee of

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party for a much higher price. Justice Peckham's opinion did not rely exclusively on either the special importance of the undisclosed information or the fiduciary relationship between the director and shareholder, but held that the coexistence of both factors created a duty to disclose the information before purchasing the minority shareholder's interest.

Tension between the two theories derives in large part from the conflict between the two major ideals of the federal securities laws: fairness to all investors and efficient markets for capital. *See* Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 333-339 (1979). In the eyes of some, the best way to achieve both fairness and efficiency is to give all investors equal access to all relevant information. Proponents of this view argue that unequal access to information impairs the efficiency of capital markets, since businesses must pay premiums to attract capital from investors wary of being cheated by those with better access to information. Others argue that the "information" theory goes too far in preventing trading on confidential information. They claim that market prices reflect a collective judgment as to what securities are worth, taking into account all the information available to any of the purchasers and sellers, as well as their evaluations of the relative importance and reliability of each item of information. Although only the wealthiest investors can afford to gather and evaluate all the available information about investment opportunities, even the smallest investor can open a newspaper and learn the price at which a security is being traded on any given day, at least if the security is traded in a large, well-organized, public market. Thus those who follow this line argue that what is most "fair" is to make certain that all information available to anyone is incorporated swiftly into market prices through purchases or sales. They object to the "information" theory because it requires expensive, time-consuming dissemination of information before trading can begin, and it leads to sharp, sudden changes in market price rather than continuous adjustment.

The federal securities laws as we must apply them are not predicated exclusively on one or the other view. The existing

a financial printer. Because he worked setting type for documents to be used in connection with tender offers, Chiarella was able to learn which companies were about to be the targets of tender offers at above-market prices. He would buy stock in the target companies before the offers were announced and sell afterwards at a considerable profit. When his activities were discovered, the government prosecuted him under 15 U.S.C. § 78ff(a) (1976), which subjects those who willfully violate Rule 10b-5 and Section 10(b) of the Securities Exchange Act to criminal liability. Chiarella was convicted and the Second Circuit affirmed the conviction, holding that anyone who regularly receives material, nonpublic information has a duty to disclose the information or refrain from trading. 588 F.2d 1358, 1365 (2d Cir. 1978). The Supreme Court reversed.

Five Justices joined a majority opinion written by Justice Powell. It begins by noting that neither Section 10(b) nor its legislative history, nor the history of Rule 10b-5 itself, offers clear authority for imposing a disclose-or-refrain obligation on anyone. The opinion then traces the progression of cases that recognize such an obligation, rationalizing them on the principle of fiduciary duty, and rejecting the argument that there is "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information," 445 U.S. at 233. The majority opinion states:

> Thus, administrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a

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legal rules have evolved as a set of compromises in Congress and before the SEC—often political and usually inconsistent—between the two theoretical ideals. We recognize both that full equality of access to information is an illusory goal and that the public is quick to perceive unfairness when insiders and their cronies can enter the market and extract large profits on the basis of information unavailable to others.

> fraud actionable under § 10(b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure. But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction. Application of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information.

Id. at 230.

The majority opinion deals with the liability of those who receive information, *see Shapiro v. Merrill Lynch*, *supra*, in a footnote appended to the above statement:

> "Tippees" [persons who receive information] of corporate insiders have been held liable under § 10(b) because they have a duty not to profit from the use of inside information that they know is confidential and know or should know came from a corporate insider. * * * The tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty.

445 U.S. at 230 n.12.

Other Justices, however, advanced slightly different theories of when a duty to disclose-or-refrain should arise. Four Justices stated that they thought the duty could be grounded on something other than a relationship of trust between the parties to a securities transaction. The Chief Justice and Justice Brennan, each writing separately, stated their belief that "a person violates § 10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities." 445 U.S. at 239 (Brennan, J., concurring in the judgment); *cf. id.* at 249 (Burger, C.J., dissenting) (duty to disclose-or-refrain arises "when an informational ad-

vantage is obtained * * * by some unlawful means"). Justice Blackmun, joined by Justice Marshall, agreed that misappropriation of information could give rise to a duty to disclose-or-refrain, but he stated that he would go further, imposing the duty on all "persons having access to confidential material information not available to others generally," *id.* at 251, or indeed perhaps on anyone who "turn[ed] secret information to account for personal profit," *id.* at 249. And Justice Stevens, whose vote was necessary to give Justice Powell's opinion a majority, indicated that he considered it an open question whether the duty to disclose-or-refrain could be premised on yet another theory: a duty of confidentiality owed to someone other than a purchaser or seller of the security at issue. *See id.* at 237-238.

The *Chiarella* majority's statement of its holding, nonetheless, is narrower than the reasoning in any of the opinions: "a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information." 445 U.S. at 235. Although it is clear that the reasoning of the Justices in *Chiarella* must inform our consideration of the question before us, the narrowness of the holding in *Chiarella* cautions against applying the majority's rationale rigidly or exclusively to contexts involving information other than "market" information. The disputes among the Justices in *Chiarella* lead us to doubt that it will be the Supreme Court's last word on Rule 10b-5.

Therefore, reading *Chiarella* in light of the case law that preceded it, and extracting those views that seem to command a clear majority of the Court, we take the following lessons from *Chiarella*: Rule 10b-5 and its statutory sources, standing alone, do not require "any person" who is a party to a securities transaction to disclose all material, nonpublic information or refrain from trading, and a mere failure to disclose material information, absent other compelling legal circumstances, does not "operate as a fraud." Thus, the "information" theory

is rejected. Because the disclose-or-refrain duty is extraordinary, it attaches only when a party has legal obligations other than a mere duty to comply with the general antifraud proscriptions in the federal antitrust laws.

The duty of loyalty owed by corporate officers to a corporation and its shareholders is one obvious example of a legal duty that, in conjunction with Rule 10b-5, gives rise to an obligation to disclose-or-refrain. But the law of fiduciary duties is not coextensive with Rule 10b-5. *See Goldberg v. Meridor*, 567 F.2d 209, 220-221 (2d Cir. 1977), *cert denied*, 434 U.S. 1069 (1978). Fiduciaries may violate Rule 10b-5's disclose-or-refrain prescription even if their actions do not violate their fiduciary duties as defined by state law. *E.g., Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1971). Furthermore, the disclose-or-refrain rule extends to other relationships of trust, whether or not they are subject to fiduciary duties under state law. *See, e.g., Affiliated Ute Citizens, supra* (employees of a bank acting as stock transfer agent who "facilitated" sales of shares); *Capital Gains Research Bureau, supra* (financial adviser, under the Investment Advisers Act of 1940); *Zweig v. Hearst Corp.*, 594 F.2d 1261 (9th Cir. 1979) (financial columnist).

As we show in Part III, Dirks had a duty to disclose what he knew about Equity Funding to the public or to refrain from trading (or fostering trades) in Equity Funding securities. He violated that duty, and with it Rule 10b-5, when he passed his information to investors who were likely to sell their Equity Funding securities before the public learned about the Equity Funding fraud.

III

The SEC's opinion states:

> It is well established that corporate insiders who trade on the basis of material, non-public information, without first disclosing it, violate Section 10(b)

> of the Securities Exchange Act and Rule 10b-5 thereunder. "Tippees" of corporate insiders, who themselves trade, are equally liable. Moreover, both corporate insiders and their "tippees" are liable for trading violations of those whom they, in turn, "tip." The dissemination of inside information to those who utilize it in dealing with uninformed public investors constitutes an act, practice, or course of conduct which operates as a fraud on investors. Even where the tipper does not himself engage in trading, he aids and abets the violation by providing the means by which the wrongful act occurs.

JA 1321 (footnotes omitted). The SEC's theory of this case rests almost entirely on the fourth sentence of this passage. In the SEC's view, Dirks aided and abetted violations of Rule 10b-5 by selectively disseminating inside information to investors likely to sell their Equity Funding stock without making a public disclosure of what they learned from Dirks.

Relying on *Chiarella*, Dirks attacks this line of reasoning in a number of ways. He argues that his actions did not violate Rule 10b-5 unless the corporate insiders who disclosed the information in the first place also violated Rule 10b-5, and that they did not violate Rule 10b-5 because their fiduciary duties under California law did not require them to keep the information they gave Dirks confidential. He also argues that information is not "inside information" unless there is an enforceable duty to keep it confidential for corporate purposes, or that selective dissemination does not operate as a fraud unless those responsible have a duty to maintain confidentiality. Each of these arguments comes down to the same thing. After *Chiarella*, Dirks argues, neither he nor his informants can be held to violate Rule 10b-5 unless they breached some legal duty to Equity Funding to keep what they knew of its crimes secret. And Dirks asserts that neither California law nor any other law creates such a duty.

The SEC does not dispute that Dirks' informants—Secrist, Hopper, Goff, *et al.*—had no duty under California law to maintain confidentiality about the Equity Funding fraud, and we may assume, without deciding the question, that California law relieves corporate employees of their duty to keep corporate information confidential when it relates to crimes or frauds perpetrated by the corporation.[15] Even if none of Dirks' informants breached their fiduciary duties in disclosing what they knew of Equity Funding's false insurance scheme to

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[15] While it may be questioned whether all of Dirks' informants retained a fiduciary duty to Equity Funding and its shareholders, *see* Heller, *supra* note 1, at 552-554, there is little doubt that some of his sources had a duty of loyalty to Equity Funding and its shareholders. These include Patrick Hopper, who had been an officer and major shareholder of Equity Funding, Ronald Secrist, a relatively high-ranking employee who had left his job with Equity Funding only two and a half months before contacting Dirks, and Donald Goff, a current Equity Funding employee. Hopper and Secrist closely guided Dirks' investigation.

Despite the SEC's failure to dispute the issue, it is not clear that California law would permit Dirks' informants to secretly provide information about Equity Funding to Dirks with reason to believe that he would profit by it. Fiduciaries in California may not extract a profit to the exclusion of those to whom they owe a duty of loyalty without making full disclosure. *See MacIssac v. Pozzo*, 26 Cal.2d 809 (1945); *Topanga Corp. v. Gentile*, 249 Cal.App.2d 681 (2d Dist. 1967). Furthermore, they may not profit from a breach of their fiduciary duties, even if the profit is not at the expense or to the exclusion of a beneficiary. *See Lemer v. Boise Cascade, Inc.*, 107 Cal.App.3d 1 (1st Dist. 1980). Yet there is no clear authority proscribing secret profits, not at the expense of a beneficiary, that do not involve a breach of duty. We have assumed that Dirks' informants did not breach their fiduciary duties to Equity Funding simply by disclosing what they knew of its fraudulent practices, and we cannot predict whether California courts would hold that it was a breach of fiduciary duty to disclose their information to someone who might foreseeably use the information to make a profit. Under the circumstances, we need not decide this difficult question of state law.

Dirks, Rule 10b-5 may prohibit Dirks and his clients from profiting on the basis of their knowledge before public exposure of the fraud.

First, there is a clear fallacy in Dirks' argument that he cannot have violated Rule 10b-5 because his informants did not violate their fiduciary duties as defined by California law. While the standards of Rule 10b-5 have always duplicated state fiduciary obligations to a certain extent, courts have never regarded the two as identical. In *Chasins v. Smith, Barney & Co., supra*, the court sustained a verdict that the defendant had violated Rule 10b-5 but that it had not violated New York's law of fiduciary duty. And in *Goldberg v. Meridor, supra*, the Second Circuit explained that, in a case involving failure to disclose material information, the existence of parallel state remedies neither defined nor precluded application of Rule 10b-5. *See* 567 F.2d at 221. The *Chiarella* majority focused on the existence of a set of fiduciary obligations as a prerequisite to the addition of a disclosure-or-refrain duty, but it did not hold that *breach* of the fiduciary obligations was required to bring Rule 10b-5 to bear on a case, nor did it hold that state fiduciary law was the sole source of the duty to disclose-or-refrain.

To say that Dirks' informants did not breach their fiduciary obligations under California law is not to say that the federal government must permit them to enter the market for securities and, on the basis of their knowledge that Equity Funding was defrauding the public, extract a profit from uninformed investors. No matter what standard of conduct state law sets, Rule 10b-5 may require those who are fiduciaries under state law to disclose material information they have learned in the course of their fiduciary relationships before trading in securities. Other courts interpreting *Chiarella* have reached similar conclusions. *See Staffin v. Greenberg*, —— F.2d ——, —— (3d Cir. No. 81-1666, decided

Feb. 19, 1981) (slip op. at 14); *United States v. Newman*, 664 F.2d 12, 17-18 (2d Cir. 1981). And under the doctrine of *Shapiro v. Merrill Lynch*, *supra*, and *Investors Management*, *supra*, the obligations of corporate fiduciaries pass to all those to whom they disclose their information before it has been disseminated to the public at large. Thus Dirks (and through him his clients) became subject to his informants' disclose-or-refrain obligation.[16]

That is not to say that it will always be irrelevant under Rule 10b-5 that no fiduciary duty was breached in communicating information. In this case—assuming still that Dirks is correct about California law—California had good reason to release corporate employees from their duty to keep corporate information confidential when the information concerns corporate crimes or frauds. Both the state and the public at large have an interest in exposing corporate misconduct. Ordinarily, we would expect that official law enforcement agencies would be sufficient for that task, but this case shows that the organs of government are not always able to accomplish swift

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[16] A footnote in *Chiarella* commented that the *Shapiro v. Merrill Lynch* doctrine "has been viewed as arising from [the tippee's] role as a participant after the fact in the insider's breach of fiduciary duty." 445 U.S. at 230 n.12; *see* p. 19 *supra*. We do not think that the Supreme Court meant this footnote to imply that application of the *Shapiro v. Merrill Lynch* doctrine requires breach of fiduciary duty even if breach is not required to make the insiders themselves liable. Nor do we think it means that breach by insiders is necessary to make their "tippees" answerable for acts that would have constituted a breach had they been committed by the insiders. *See* Langevoort, *supra* note 1, at 30-31; *Investors Management Co.*, 44 S.E.C. 633, 645 (1971). *But see* 44 S.E.C. at 650 (Commissioner Smith concurring in the result) (suggesting that breach by the insider-informants should be required to hold tippees liable).

investigation of possible crimes.[17] The press also has an historic role in discovering and exposing wrongdoing, but here, too, the press failed to move as quickly as Dirks, who had more immediate financial and reputational incentives to discover the truth about Equity Funding. Interpreting Rule 10b-5 so as to categorically prevent private sector investigators from contacting corporate employees and asking them about crimes or frauds that their employer is committing may not, in the end, serve the public interest.[18]

To paraphrase Justice Cardozo in another context: With respect to imposition of the disclose-or-refrain rule where fiduciary obligations are not violated, we do not fix the outermost line. Wherever the line may be, this case is within it. *Steward Machine Co. v. Davis*, 301 U.S. 548, 591 (1937). In the first place, we do not write on a clean slate. The SEC, charged with administering the nation's securities laws, is clearly entitled to deference when it interprets its own regulations in an administrative adjudication.[19] *See Udall v. Tallman*, 380 U.S.

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[17] *See* note 6 *supra*.

[18] Professor Brudney suggests that there should be no liability under Rule 10b-5 for trading on the basis of information that would be *lawfully* available to others. *See* Brudney, *supra* note 14, at 359-365; *cf.* Langevoort, *supra* note 1, at 27 ("if the insider has a legitimate business purpose in communicating the information, there would be no fraudulent misconduct").

[19] There is, of course, a private right of action to enforce § 10(b) and Rule 10b-5. *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971). Our deference to an administrative construction in this case does not imply that we would hold Dirks liable in a private action for damages. To affirm an agency's construction of a statute in an administrative proceeding "it is not necessary for a court to find that the agency's construction was the only reasonable one or even the reading the court would have reached if the question initially had arisen in a judicial proceeding." *FEC v. Democratic Senatorial Campaign Committee*, —— U.S. ——, ——, 50 U.S.L.W. 4001, 4004 (Nov. 10,

1, 16-17 (1965). It has decided to censure Dirks under Rule 10b-5, and we cannot say that the SEC's disposition is "inconsistent with the statutory mandate" behind Rule 10b-5 or that it "frustrate[s] the policy that Congress sought to implement." *See FEC v. Democratic Senatorial Campaign Committee*, —— U.S. ——, ——, 50 U.S.L.W. 4001, 4002 (Nov. 10, 1981); *SEC v. Sloan*, 436 U.S. 103, 118 (1978).

Even more important, Dirks himself had obligations to the SEC and to the public completely independent of any obligations he acquired under the *Shapiro v. Merrill Lynch* doctrine. Those obligations, implicit in the scheme of broker-dealer registration under the federal securities laws, provide a basis for imposing a duty to disclose-or-refrain on Dirks even if we would not impose it on his sources at Equity Funding.

The Securities Exchange Act of 1934 subjects registered broker-dealers, like Delafield Childs, and those associated with them, like Dirks, to myriad duties not imposed on corporate officers or other members of the general public. These include a registration requirement, 15 U.S.C. § 78*o*(a)-(b) (1976), and special requirements to avoid practices that would operate as a fraud, *id.* § 78*o*(c)(1)-(6); *see* 17 C.F.R. §§ 240.10b-3, .15c1-2, .15c1-4 (1981). Even before the promulgation of Rule 10b-5, the SEC and the courts held that, because of the importance of broker-dealers within the securities markets and the general scheme of securities regulation, broker-dealers were required to meet a high standard of ethical behavior in their activities. *See Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944); *Duker & Duker*, 6 S.E.C. 386

1981). In addition, a private action for damages might raise questions of standing, causation, and appropriate remedy not pertinent here. We note that the SEC itself has taken care to impose a mild sanction in this case. *See* p. 12 *supra*; JA 1330.

(1939). The Second Circuit has even stated that Rule 10b-5, as applied to broker-dealers, might reach the sort of non-deceptive breach of fiduciary duty that does not come within the rule as applied to corporate managers. *Compare O'Neill v. Maytag*, 339 F.2d 764, 768-769 (2d Cir. 1964), *with Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), *and Santa Fe Industries, Inc. v. Green, supra.*[20]

To be sure, the main focus of the SEC's regulation of broker-dealers has been to ensure that broker-dealers treat their customers honestly and fairly. But fairness to their customers is not the only obligation that the securities laws impose on broker-dealers. The Supreme Court has held repeatedly that the scheme of federal securities regulation, taken as a whole, has a major objective "to achieve a high standard of business ethics * * * *in every facet of the securities industry.*" *United States v. Naftalin*, 441 U.S. 768, 775 (1979) (emphasis in original); *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186-187 (1963); *cf. Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976). And in enacting the first major piece of securities legislation, the Securities Act of 1933, Congress clearly announced the fundamental purpose of its regulation of the securities markets:

> The purpose of this bill is to protect the investing public and honest business. * * * The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked pro-

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[20] *See generally* Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 CORNELL L. REV. 869, 876-881 (1972).

> motion; to restore the confidence of the prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.

S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933); *see United States v. Naftalin, supra*, 441 U.S. at 775-776.[21]

There is no identifiable segment of the securities industry whose ethical conduct is more crucial to the attainment of Congress' goals than the ethical conduct of broker-dealers. The high standard of business ethics required by the securities laws restrains broker-dealers not only in their dealings with their customers, but also in their dealings with the SEC and the public at large, at least when the alternative is direct frustration of the federal scheme of securities regulation.

This case provides a clear example of a duty to the SEC and the public created by the ethical standard that applies to broker-dealers. Dirks discovered an ongoing fraud that meant, at the very least, that the stock of Equity Funding was being traded at prices far in excess of the value which any reasonable investor, fully informed, would place upon it. As the public learned the

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[21] The legislative history of the Securities Exchange Act of 1934, which authorized promulgation of Rule 10b-5, demonstrates Congress' understanding that fiduciary relationships have implications for the economy as a whole, and that securities professionals regulated by the Act would owe certain responsibilities to the public at large as well as to their clients. *See* H.R. Rep. No. 1383, 73d Cong., 2d Sess. 5 (1934):

> Unless constant extension of the legal conception of a fiduciary relationship—a guarantee of "straight shooting"—supports the constant extension of mutual confidence which is the foundation of a maturing and complicated economic system, easy liquidity of the resources in which wealth is invested is a danger rather than a prop to the stability of that system.

full extent of the Equity Funding fraud, its stock became first illiquid, then worthless. By the time Dirks entered the picture, a loss amounting to many millions of dollars to the investing public was already unavoidable. But, instead of going straight to the SEC with what he had learned, Dirks paused to make certain that his clients and those who might some day become his clients—all large institutional investors—were not the ones left "holding the bag." Dirks therefore risked that much of the loss would be borne by relatively smaller, less sophisticated investors.

Dirks' conduct was fundamentally inconsistent with "prevent[ing] further exploitation of the public by the sale of unsound, fraudulent, and worthless securities." There is no question that securities industry professionals may legitimately engage in securities analysis for the benefit of their clients, and they may accumulate and sell information in order to make a profit. In the common run of day-to-day business, professional securities analysis is perhaps the best way to aggregate and evaluate information in the securities markets; the analysts thus serve themselves, their clients, and the public interest in efficient capital markets all at the same time. But it is intrinsic in our notion of "business ethics" that at some point we are not content to let securities analysts' quest for fees and commissions define their obligations to the public at large. In this case, the role of analysis-for-hire ceased when its unavoidable result was to foster the sale of "unsound, fraudulent, and worthless securities" to the uninformed public. At the very least, Dirks owed a duty to report what he had learned to the SEC and not to foster such sales.

That fundamental obligation would inhere in the securities laws enacted by Congress even if they included no generally applicable antifraud provisions. As it is, Rule 10b-5 operates in conjunction with the ethical duty implied by the other provisions of the securities laws

to forbid broker-dealers, and those who obtain information from them, to trade in unsound, worthless, or fraudulent securities without first disclosing the material information they possess. The public and the SEC both have a right to expect good-faith cooperation from securities industry professionals in accomplishing the core purposes of the securities laws. Dirks violated his duties to the SEC and the public by failing to report promptly what he knew. When his clients sold their Equity Funding stock without first disclosing the information Dirks had given them, they became "participant[s] after the fact" in Dirks' breach of duty, *see Chiarella, supra*, 445 U.S. at 230 n.12, and they violated Rule 10b-5.

IV

Dirks raises two further challenges to the SEC's decision in this case. First, he disputes that the information he passed on to his clients constituted "material facts." Second, he claims that the SEC applied the wrong scienter standard in finding that he had aided or abetted his clients' violation of Rule 10b-5. Neither of these contentions has merit.

A. *Material Facts*

The disclose-or-refrain obligation does not extend to everything a trader knows or believes. It applies only to "material facts" that have not yet been disseminated to the public. *See SEC v. Texas Gulf Sulphur Co., supra*, 401 F.2d at 848-850; *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965). Dirks argues both that the information he gave his clients was not "factual" enough to come within the disclose-or-refrain rule and that it could not be deemed "material" to his clients' decisions to sell their Equity Funding stock.

To the extent that Dirks attacks the SEC's findings of fact, our review is strictly limited. "The findings of the

Commission as to the facts, if supported by substantial evidence, are conclusive." 15 U.S.C. § 78y(a)(4) (1976). We review the SEC's findings only to judge whether there is substantial evidence in the record from which a reasonable person might find a violation of Rule 10b-5 by a preponderance of the evidence. *See Steadman v. SEC*, 450 U.S. 91 (1981).

Dirks challenges both the legal and factual adequacy of the SEC's finding that the information he communicated was material. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976), states the test for materiality. An omission is material if "the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." Although the SEC's opinion cites the correct language in *TSC Industries*, *see* JA 1324, Dirks claims that the SEC was really applying a test derived from the *Texas Gulf Sulphur* case, weighing the probability that the omitted fact is true against the magnitude of its effect on the market if it is true, *see* 401 F.2d at 849. According to Dirks, the "probability/magnitude" test makes even the least probable rumors "material" if they are sensational enough, and Dirks maintains that *TSC Industries* rejected the probability/magnitude test in *Texas Gulf Sulphur*.

Although the *TSC Industries* test is more sensitive than the probability/magnitude test, since it takes into account not only how a reasonable investor would evaluate a single piece of information in isolation but also how one fact relates to all the others available to a reasonable investor, it is simply a case of the greater including the lesser. *TSC Industries* did not reject any balancing of probability and magnitude of effect; indeed, it is hard to conceive of a better description of what a "reasonable investor" would do. It merely injects another factor into the overall consideration—how the probability/magnitude calculation with respect to one piece

of information changes the calculation as applied to all available information. The SEC's opinion (and the hearing examiner upon whom the SEC relied) takes both factors into account, as have many courts since *TSC Industries*.[22]

Dirks asserts that one of the footnotes in the SEC's opinion demonstrates further departure from the *TSC Industries* standard and also shows that the SEC based its decision on factual predicates that were not established by substantial evidence on the record. The SEC's opinion states, "The fact that some tipped advisers 'acted immediately or very shortly after receipt of the information to effect sales * * * is in itself evidence of its materiality.'" JA 1324 n.33 (citing *Investors Management, supra*, 44 S.E.C. at 642). The SEC regarded this as only one indication that investors, who might have been reasonable, considered the information Dirks gave them material. Many courts have looked to similar evidence, both before and after *TSC Industries*.[23] Where, as here, the SEC does not treat evidence of actual behavior as dispositive, *TSC Industries* surely does not forbid adverting to it.

Not all of Dirks' clients sold their Equity Funding stock immediately or shortly after receiving his information. Some continued to hold Equity Funding securities even after learning of Dirks' suspicions, and at least one sophisticated investor, Loew's, Inc., continued to buy Equity Funding stock after being warned by Dirks of the possibility of fraud. Yet those who ignored Dirks' infor-

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[22] *See, e.g., State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 854 (2d Cir. 1981); *McGrath v. Zenith Corp.*, 651 F.2d 458, 466-467 (7th Cir.), *cert. denied*, —— U.S. ——, 50 U.S.L.W. 3246 (Oct. 5, 1981); *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 17-18 (2d Cir. 1977).

[23] *See, e.g., Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 166-167 (2d Cir. 1980); *SEC v. Shapiro*, 494 F.2d 1301, 1307 (2d Cir. 1974).

mation were generally those with whom Dirks spoke before the crucial period of March 21-26, when Dirks obtained corroboration for Secrist's charges; investors with whom Dirks communicated during the final week of his investigation, especially on March 23 and March 26, understandably tended to sell whatever Equity Funding stock they could.

Since the SEC imposed the mildest penalty available to it under 15 U.S.C. § 78*o*(b)(4) (1976), the evidence in the record is substantial enough to support the disposition if a reasonable person could infer from it the facts necessary to find a single violation of Rule 10b-5 by a preponderance of the evidence. The record before the SEC easily passes that test. The extensive sales by Dirks' clients on March 23 and March 26-27 render irrelevant any ambiguities in the record relating to sales before those dates.[24]

Finally, Dirks argues that, as a matter of law, the information he communicated was not specific enough to rise to the level of "fact." Unless a "tip" comes from a source whose word would not be doubted, there can be no violation of Rule 10b-5 for failure to disclose information that "lack[s] the basic elements of specificity." *See SEC v. Monarch Fund*, 608 F.2d 938, 942 (2d Cir. 1979). But by the end of Dirks' investigation there is no doubt that the information he possessed and passed on to his clients had enough specificity to satisfy Rule 10b-5. He knew of specific blocks of false insurance, and he had

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[24] Nor is it relevant that some of Secrist's charges eventually proved false. Although Dirks may have discussed those charges with his clients early in his investigation, by the week of March 20 he was clearly focusing on the false insurance allegation that he later corroborated. The record shows that his conversations during the crucial March 23-26 period related exclusively to charges that he knew by that time were substantially true. *See* Initial Decision, *supra* note 4, at 97-103 (JA 1232-1238).

a very detailed idea of how Equity Funding had gone about fooling its auditors and regulators. Thus, the information involved in this case is totally unlike the general rumors that the *Monarch Fund* court found not specific enough to support Rule 10b-5 liability. *Cf. Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 164 (2d Cir. 1980) (comments by corporate officers like "we expect another good year" were not specific enough to mislead the sophisticated investors to whom they were addressed); *Pachter v. Merrill Lynch, Pierce, Fenner & Smith*, 444 F.Supp. 417, 422 (E.D. N.Y.), *aff'd mem.*, 594 F.2d 852 (2d Cir. 1978) (a broker who had heard rumors of fraud at Equity Funding did not have a duty to disclose them to a client who submitted an unsolicited "buy" order on the morning of March 27).

Therefore, we affirm the SEC's determination that Dirks communicated "material facts" to his clients.

B. *Aiding or Abetting Scienter*

To be liable for aiding or abetting a violation of Rule 10b-5, the purported aider-or-abettor must have "a general awareness that his role was part of an overall activity that was improper" and must "knowingly and substantially assist[] the principal violation." *Investors Research Corp. v. SEC*, 628 F.2d 168, 178 (D.C. Cir.), *cert. denied*, 449 U.S. 919 (1980); *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 94 (5th Cir. 1975).[25] The SEC's

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[25] *See also SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). The test in *Investors Research* and *Metro Bank* is actually a three-part test:

> 1) another party has committed a securities law violation; 2) the accused aider and abetter had a general awareness that his role was part of an overall activity that was improper; and 3) the accused aider and abetter knowingly and substantially assisted the principal violation.

628 F.2d at 178. Both courts derived the three-part test from Ruder, *Multiple Defendants in Securities Law Fraud Cases:*

opinion contains the somewhat conclusory finding that "Dirks did act with the requisite scienter." JA 1328.

Dirks attacks the SEC's scienter finding on two grounds. First, he argues that at worst he was reckless as to the possibility that his clients would trade without disclosing the information he gave them, and that *Investors Research* does not permit aiding-or-abetting liability for mere recklessness. Second, he argues that the fact that he was constantly badgering the *Wall Street Journal*'s Los Angeles bureau to do a story on Equity Funding rebuts any evidence as to scienter, as it shows that he could not have been aware that his role was part of an overall activity that was improper.

Even if all the record showed were recklessness,[26] the SEC would be justified in censuring Dirks. In both *Ernst & Ernst v. Hochfelder*, *supra*, 425 U.S. at 193 n.12, and *Aaron v. SEC*, 446 U.S. 680, 686 n.5 (1980), the Supreme Court expressly reserved the question whether the Rule 10b-5 scienter standard includes recklessness. But the overwhelming rule in the Courts of Appeals—including the Fifth Circuit, whose *Metro Bank*

Aiding and Abetting, Conspiracy, In Pari Delicto, *Indemnification, and Contribution,* 120 U. PA. L. REV. 597, 628-638 (1972).

[26] It is open to question whether the SEC found that Dirks was merely reckless. Although it discussed recklessness in a footnote, *see* JA 1328 n.47, it was responding to arguments that Dirks had raised concerning the hearing examiner's Initial Decision, not stating its own findings of fact. There was substantial evidence in the record from which the SEC could have concluded that Dirks knew that his clients would sell their Equity Funding securities, and even that he intended that result. *See, e.g.*, Initial Decision, *supra* note 4, at 48 (JA 1183) (Dirks told the president of John W. Bristol & Co. that "if he were in my position he would sell the stock"); *id.* at 101 (JA 1236) (Dirks did not relate his fraud allegations to a company once he learned that it owned no Equity Funding securities).

language this circuit borrowed in *Investors Research*—is that recklessness satisfies the Rule 10b-5 scienter requirement.[27] *Investors Research* and *Metro Bank* do not imply that "knowingly * * * assist" or "general awareness" require a higher standard for aiding or abetting liability than the general scienter standard required by *Ernst & Ernst*.[28] Recklessness would have been enough.

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[27] *See Broad v. Rockwell International Corp.*, 642 F.2d 929, 961 (5th Cir.) (*en banc*), *cert. denied*, —— U.S. ——, 50 U.S.L.W. 3351 (Nov. 2, 1981); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1332, 1337 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1039-1040 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977). Some of the cases in effect require a "gross recklessness" standard. *See Broad, supra*; *Sundstrand, supra*, 553 F.2d at 1045. The cases also hold that a recklessness standard is most appropriate where the alleged violator has a duty to disclose or refrain from trading. *See Rolf, supra*, 570 F.2d at 45.

[28] Both cases make clear that they were adopting the "general awareness" and "knowing and substantial assistance" standards to foreclose the possibility of imposing liability in certain circumstances not even remotely similar to those in this case. This court stated in *Investors Research*: "The awareness of wrong-doing requirement for aiding and abetting liability is designed to insure that innocent, incidental participants in transactions later found to be illegal are not subjected to harsh civil, criminal, or administrative penalties." 628 F.2d at 177. Both *Investors Research* and *Metro Bank* refer to a passage in the Ruder article that identifies the problem to which the aiding and abetting standard is addressed:

> If all that is required in order to impose liability for aiding and abetting is that illegal activity under the securities laws exists and that a secondary defendant, such as a bank, gave aid to that illegal activity, the act of loaning funds to the market manipulator would clearly fall within that category and would expose the bank to liability for aiding and abetting. Imposition of such liability upon banks would virtually make them insurers regarding the conduct of insiders to whom they lend money. If it is

Dirks cannot maintain, however, that he did not know that his clients would sell their Equity Funding stock on the basis of his information without making a disclosure, and his arguments about recklessness or his good faith in trying to get the *Wall Street Journal* to publish

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> assumed that an illegal scheme existed and that the bank's loan or other activity provided assistance to that scheme, some remaining distinguishing factor must be found in order to prevent such automatic liability. The bank's knowledge of the illegal scheme at the time it loaned the money or agreed to loan the money provides that additional factor. Knowledge of wrongful purpose thus becomes a crucial element in aiding and abetting on conspiracy cases.

Ruder, *supra* note 25, at 630-631. Note also that Ruder, writing before *Ernst & Ernst*, apparently believed that negligence would be sufficient to support a primary violation of Rule 10b-5. *Id.* at 631-633; *cf. Investors Research, supra*, 628 F.2d at 178 (rejecting SEC argument that negligence standard is sufficient).

Dirks relies primarily on *Edwards & Hanly v. Wells Fargo Securities Clearance Corp.*, 602 F.2d 478, 484-485 (2d Cir. 1979), *cert. denied*, 444 U.S. 1045 (1980). *Edwards & Hanly* is yet another case following *Metro Bank* with reference to the language in the Ruder article cited above. It states:

> Finding a person liable for aiding and abetting a violation of 10b-5, as distinct from committing the violation as a principal, requires something closer to an actual intent to aid in a fraud, *at least in the absence of some special relationship with the plaintiff that is fiduciary in nature.*

602 F.2d at 485 (emphasis added). *Metro Bank* itself includes a similar qualification: "Where some special duty of disclosure exists, then liability should be possible with a lesser degree of scienter." 522 F.2d at 97. Our determination that Dirks had a duty to the public and to the SEC not to foster the sale of fraudulent or worthless securities, and the overwhelming evidence that Dirks *knew* that any Equity Funding securities on the market were fraudulent or worthless, lay to rest Dirks' contention that he could not be found liable as an aider or abettor absent some extraordinary degree of scienter.

a story[29] miss the point about what he did that was wrong. Dirks was in the securities business. He made his living collecting information, analyzing it, and selling his work product to investors who would consider it valuable. The record shows that Dirks spent almost half his working hours in Los Angeles on the phone to clients or potential clients, telling them about Equity Funding. The record also shows that Dirks expected to be compensated for his efforts, and that indeed he was compensated by some of those to whom he passed information. The only basis upon which he could have expected compensation was that his clients would consider his information worth paying for, and the only information his clients were willing to pay for was information that would help them make money in the securities markets. The Equity Funding information would have

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[29] Dirks' efforts to get the *Wall Street Journal* to publish a story do not preclude a finding that he acted with scienter. Dirks relies on *SEC v. Bausch & Lomb, Inc.*, 420 F.Supp. 1226, 1242 (S.D. N.Y. 1976), *aff'd*, 565 F.2d 8 (2d Cir. 1977), in which the court found that Bausch & Lomb's chairman did not act with scienter when he inadvertently disclosed material information to a securities analyst, because he took immediate steps to ensure public dissemination of the information. *Bausch & Lomb*'s scienter holding must be read narrowly, in the light of the particular facts of that case; it cannot mean that corporate insiders can give a favored trader a few hours' head start on the rest of the market and then insulate themselves from liability by seeking to disclose their material information generally. The chairman in *Bausch & Lomb* did not mean to disclose new information to the analyst in that case, and in any event the informational disparity between the analyst and the rest of the market lasted only a few hours. In this case, Dirks intentionally disclosed the information he had, even though he knew that the *Wall Street Journal* would not publish a story in the foreseeable future. His attempt to disseminate information via the *Wall Street Journal* did not relieve him of the responsibility to inform the SEC, to take care not to foster the sale of worthless or fraudulent securities, and to respect the disclose-or-refrain obligation of his informants.

been worth little to them unless they could sell their holdings, and it would have lost most of its value if they had disclosed it before selling.

The Second Circuit, in *Elkind v. Liggett & Myers*, *supra*, has held that the scienter standard in Rule 10b-5 was satisfied when corporate officers knowingly disclosed information they knew was material and not public to one who might "reasonably be expected to use it to his advantage." 635 F.2d at 167. The Liggett & Myers officers, who had a duty to keep corporate information confidential or disclose it to all shareholders, acted knowingly with respect to disclosure, even though they may only have been reckless or negligent with respect to the trading of those whom they informed. Dirks also acted knowingly when he passed on his information to clients before going to the SEC, in violation of his duty to the public and the SEC and in violation of his informants' disclose-or-refrain obligations. Therefore it is not precisely relevant whether Dirks subjectively "knew" that his clients would trade. He knowingly took improper actions that put parties who were reasonably likely to trade without disclosure in a position to do so.

The record thus amply supports the SEC's finding that Dirks acted with the requisite scienter for aiding or abetting liability under Rule 10b-5.

V

By selling his information to his clients before informing the SEC, Dirks deepened the Equity Funding tragedy at the same time he was working to end it. The SEC, appropriately, has expressed the hope that its disposition in this case will not discourage legitimate efforts by securities analysts to discover the truth and communicate it to their clients. We concur. But the SEC has also concluded that Dirks' actions in this case aided and abetted a violation of Rule 10b-5, and we defer to its judgment in making the policy choices required for this

disposition. Securities analysts associated with registered broker-dealers must respect the disclose-or-refrain obligations of their corporate sources, and they must stop short of transferring the losses from a fraud to those least able to avoid them. Accordingly, the petition for review is dismissed.

APPENDIX B

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934

Rel. No. 17480/January 22, 1981

Admin. Proc. File No. 3-5068

In the Matter of

RAYMOND L. DIRKS
50-1/2 Barrow Street
New York, New York

OPINION OF THE COMMISSION

BROKER-DEALER PROCEEDINGS

Grounds for Remedial Action

Fraudulent Dissemination of Inside Information

A securities analyst received from an insider non-public information about a company and the names of additional present and former insiders of the company who would confirm the information. The information would be material if there were a reasonable probability that it was true. The analyst did not obtain significant new facts, did not engage in further research, and did not independently analyze the information. His activity with regard to the information was essentially limited to confirming its truth with additional insiders. Before and after the confirmation, he selectively disseminated the information to investment managers whom he knew were likely to, and in fact did, sell their clients' holdings of that company's securities to uninformed public investors. Under the circumstances of this case, which include mitigating factors, it is held to be in the public interest to censure the analyst for aiding and abetting the managers' violations of the antifraud provisions.

APPEARANCES:

David Bonderman, Hadrian R. Katz, David Hird and *Peter R. Maier*, of Arnold & Porter, for Raymond L. Dirks.

Donald N. Malawsky, Jason R. Gettinger and *Paul S. Maco*, of the Commission's New York Regional Office, for the Division of Enforcement.

I.

Raymond L. Dirks, a securities analyst, and the Division of Enforcement appeal from the initial decision of an administrative law judge. The law judge found that Dirks aided and abetted violations of antifraud provisions of the federal securities laws by selectively disseminating material inside information concerning widespread fraud at Equity Funding Corporation of America ("EFCA") to five registered investment advisers.[1] The advisers then liquidated most or all of their clients' EFCA holdings without making appropriate disclosure to the purchasers of those shares. The law judge concluded that Dirks should be suspended from association with any broker or dealer for sixty days. The Division seeks an increase in that sanction. On the basis of an independent review of the record, we make the following findings.[2]

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[1] The advisers in question, who were also named as respondents herein, were The Boston Company Institutional Investors, Inc., John W. Bristol & Co., Inc., The Dreyfus Corporation, Manning & Napier, and Tomlin, Zimmerman & Parmelee, Inc. The law judge found that all of these firms violated antifraud provisions. He censured all except Dreyfus, on which no sanction was imposed. No appeal was taken with respect to these respondents, and the initial decision with respect to them has become final.

[2] Our findings, like those of the administrative law judge, are based on a clear and convincing standard of proof.

II.

In March 1973, Dirks was a securities analyst, well-known for his investigative talents, who specialized in insurance stocks at a New York broker-dealer firm, Delafield Childs, Inc., where he dealt exclusively with institutional clients.[3] EFCA was a substantially diversified company, primarily engaged in selling life insurance and mutual funds, as well as programs combining the two.[4] Dirks had never made a detailed analysis of EFCA.

On March 6, 1973, Dirks received a telephone call from Ronald Secrist, who identified himself as a former EFCA employee.[5] Secrist claimed that one third of EFCA's reported life insurance business did not exist and that the firm was engaged in other fraudulent conduct. During the conversation, he arranged to meet with Dirks on the following day. On March 7, Dirks and an associate met for over three hours with Secrist, who described in detail rampant fraud at EFCA reaching to the top echelons of management. Specifically, Secrist painted the following picture.

Since 1970, EFCA had been creating fictitious life insurance policies, known to insiders as "Y business." These policies were sold to reinsurers for an amount equal to 80% of first-year

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[3] Dirks received a salary for his analytical services plus a commission for securities transactions above a certain amount which his clients directed through Delafield Childs.

[4] EFCA conducted its operations through a number of subsidiaries, which included several life insurance companies, broker-dealers, investment advisers and a savings and loan association.

[5] Until February 19, 1973, Secrist had been a vice president of EFCA, where he performed general administrative work and coordinated data processing and life insurance claims. Although Secrist told Dirks that he had resigned, Dirks later learned that Secrist had been fired.

premiums.[6] By this method, management hoped to generate cash flow, maintain an impressive growth rate and boost the value of EFCA stock. In some cases, legitimate policies were reinsured for more than their face amount, while at other times totally fictitious policies were created. To carry out this scheme, EFCA created supporting files, medical records and death certificates for non-existent policy holders, bribed and intimidated some of its auditors and state examiners, and falsified its financial records to show the receipt and disposition of non-existent premiums.[7] Secrist claimed that he had actually witnessed the creation of fictitious files which were used to deceive EFCA's auditors. He asserted that, as a result of such activities, many EFCA employees had left the company. He estimated that, by 1972, EFCA carried at least 40,000 fictitious policies on its books, representing at least one-third of EFCA's outstanding life insurance business.

Secrist further stated that regulatory agencies had failed to act on similar charges made by other EFCA employees. He urged Dirks to verify the fraud and publicly disclose it. To aid Dirks' inquiry, Secrist provided the names of several present and former EFCA employees whom he stated would corroborate his allegations.[8]

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[6] Reinsurance effectively constitutes the transfer of a life insurance policy by the issuing company to another company, known as the reinsurer. The issuing company continues to service the account and transmits about 90% of the premiums to the reinsurer. Insurance companies engage in this practice in order to decrease their exposure to certain risks.

[7] Secrist said that, in order to reflect the receipt of such premiums, EFCA printed counterfeit certificates of deposit and bank statements showing fictitious deposits.

[8] Secrist also reported hearing that threats of violence were used to inhibit public disclosure of the fraud, and that top EFCA officials kept packed suitcases, passports and a supply of cash on hand so that they could flee the country in the event their fraud began to unravel.

On March 12, Dirks instructed his staff to ascertain which of Delafield's clients "had an interest" in EFCA. He was already aware from previous discussions with Gerald Zukowski, a vice president of The Boston Company Institutional Investors, Inc. ("Boston"), a registered investment adviser, that Boston had such an interest.

Late in the afternoon of March 12, Dirks telephoned Zukowski, and during a lengthy conversation, joined by Thomas Courtney, Boston's president, Dirks related in some detail the allegations concerning EFCA that he had heard from Secrist. Although Courtney and Zukowski indicated their disbelief, Dirks suggested that the allegations should not be dismissed out of hand. That same evening, Courtney decided to liquidate all EFCA positions in the accounts that he controlled, even if it meant selling at a large loss. But the acquiescence of other officers at Boston was required, and, the next morning, they vetoed his decision as too precipitous.

Also on the morning of March 13, Courtney met for several hours with Dirks who, using extensive notes from his meeting with Secrist, relayed the details of the fraud allegations. Upon Courtney's return, opposition to his sales decision was withdrawn, and, on March 15 and 16, Boston sold the $1.2 million worth of securities that had been held by the accounts that Courtney controlled. On March 15, Zukowski issued instructions which resulted in Delafield earning nearly $4,000 in commissions from Boston.

Dirks, who had attempted to contact *The Wall Street Journal* on March 12, succeeded on March 19, and told Herbert Lawson, San Francisco bureau chief, about the Secrist allegations. Lawson indicated that he would refer the matter to a

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Secrist was quite uneasy about possible retribution because of his disclosures. Although Dirks received Secrist's permission to disclose Secrist's charges to *The Wall Street Journal*, Dirks did not reveal Secrist's identity to others.

Journal reporter based in Los Angeles, where EFCA had its headquarters. That same evening, Dirks flew to Los Angeles.

On March 20, Dirks met with Patrick Hopper, a former vice president in charge of investments for one of EFCA's insurance subsidiaries. Hopper was one of the people to whom Secrist had directed Dirks in order to corroborate Secrist's story. Hopper stated that, although he had no direct evidence of any fraud, he was convinced on the basis of what he had heard from others that much of what Secrist had alleged about fictitious insurance and assets was true. According to Hopper, fictitious insurance was openly discussed at EFCA, sales figures were highly irregular and suspicious, non-existent assets were carried on EFCA's books, and cash assets had been drained from EFCA subsidiaries. Hopper also stated that top management had tried to recruit him into the "inner circle of conspirators," and that many employees, including himself, had resigned rather than cooperate.

During this meeting, Dirks telephoned Zukowski. Dirks not only relayed his latest findings, but had Zukowski question Hopper directly.[9] Later that same day, Dirks met with Frank Majerus, a former EFCA comptroller and another person whose name had been supplied by Secrist. Majerus admitted having personally falsified ledgers in 1970 to conceal the fictitious nature of the insurance that was being carried on EFCA's books, and he expressed his fear of going to jail for his part in the fraud. That evening, Dirks relayed this information to Boston. On the following morning, Zukowski told Dirks that Boston was going to liquidate its clients' remaining holdings of EFCA securities, and that, irrespective of the final outcome of Dirks' inquiry, Boston would direct $25,000 in commission

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[9] Between March 12 and March 21, Dirks spoke with Zukowski as many as ten times and kept him fully apprised of the status of his inquiry.

business to Delafield.[10] The liquidation was accomplished that day for an amount in excess of $7.5 million.

On March 21, Dirks met with Stanley Goldblum, chairman of EFCA's board of directors, and stated that he had been told of fictitious insurance policies at EFCA.[11] Goldblum categorically denied the allegations, calling them preposterous in light of all the regulatory bodies policing the insurance industry. Dirks was told that rumors were being spread by some former employees who had stolen money from EFCA. He was invited to inspect the company's headquarters office and speak to other officers, which he did. During his meeting with Goldblum, Dirks learned that the market price of EFCA had dropped four points because someone, who Dirks assumed was Boston, had sold a large block of EFCA securities

Later that day, Dirks met with William Blundell, the *Journal's* Los Angeles bureau chief, and told him about the allegations involving EFCA and his meeting with management. Blundell, although highly doubtful that such a fraud could go undetected, agreed to pursue his own inquiry.

On March 22, Dirks spoke with Gene Thibodeau, who had worked in EFCA's computer department until October 1971. Mr. Thibodeau's name had also been given to Dirks by Secrist. Thibodeau confirmed Secrist's claim that fictitious insurance, known as "Y business," was being reinsured with other companies. He stated that EFCA's computer records showed that company employees were issued insurance policies in 1970 without being charged a premium, and that the names of legitimate policy holders were being used to create duplicate business which did not exist. Thibodeau did not know whether

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[10] Apparently Delafield never received this business. Dirks questioned Zukowski about the promised commissions in April.

[11] On March 12, Dirks had contacted Goldblum on the pretext of discussing EFCA's latest earnings report and obtained an invitation to visit EFCA's offices in Los Angeles at the end of the month.

these practices had continued beyond 1970, but indicated that he had resigned from EFCA because of them and was glad that they were now being investigated.

On March 23, Dirks spoke with two additional persons who had worked for EFCA, and one person still in the company's employ. Peter Ronchetti, who had worked in EFCA's computer department, told Dirks that he had become suspicious and conducted his own inquiry, which disclosed that there existed fictitious insurance known as "Y business." Ronchetti said that, in order to conceal this fraud, a "mass marketing department" at EFCA had created fictitious assets, as well as false death certificates and policy files. He further corroborated Secrist's statement that many members of management knew of these practices, and that he had heard that threats of violence had been used to inhibit disclosure of the fraud which accounted for 11,000 policies in 1970, 45,000 policies in 1971 and 60,000 policies by the end of 1972.

Shortly thereafter, Dirks spoke on the telephone with Brian Tickler, who had worked for a computer company that had performed services for EFCA. Tickler stated that, based on his own investigation, "he would stake his career" on the existence of fictitious insurance known as "Y business" at EFCA, at least during 1970. He asserted that, at that time, there were 10,000 to 12,000 non-existent policies which EFCA had reinsured.

Later that same day, Dirks met with Don Goff, who was still employed at EFCA as a computer systems supervisor and whose name had also been supplied by Secrist. Goff confirmed the existence of fictitious "Y business" in an amount corresponding to the figures already supplied by Ronchetti. Goff also described how EFCA created false insurance files and

mutual fund shares, using its own printing plant to produce these documents.[12]

Thus, by the afternoon of March 23, Dirks had spoken to one current and six former EFCA employees,[13] all of whom had reported the existence of widespread fraud at the company. At that point, Dirks telephoned The Dreyfus Corporation, a registered investment adviser, which, as Dirks was aware, held EFCA securities.[14] Dirks told Dreyfus that, according to several present and former EFCA employees, EFCA was carrying as many as 60,000 non-existent insurance policies on its books, and it had manufactured other fictitious assets and false death certificates. The next day, Dirks divulged the names of his sources to Dreyfus, which also quickly contacted three of them. Dirks also stated that he had contacted EFCA's accountants and did not expect the stock to continue trading much longer. On March 26, after making its own inquiry which tended to corroborate Dirks' story, Dreyfus sold a recently acquired $500,000 EFCA debenture.[15]

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[12] Dirks also learned that EFCA's auditors were about to release certified financial statements for the company on March 26. He immediately contacted them and apprised them of the fraud allegations, hoping that they would withhold release of their report and seek a halt in the trading of EFCA securities. Instead, the auditors, who met with Dirks on March 24 and made copies of his extensive notes, merely reported Dirks' allegations to EFCA management. Dirks also contacted Blundell to inform him of Dirks' latest findings, and was told that Blundell had reported the matter to this Commission.

[13] As previously noted, one of the persons to whom Dirks spoke was actually an employee of a computer firm that had performed services for EFCA.

[14] Dreyfus, learning that Dirks "had a negative story on EFCA," had contacted him the previous day.

[15] Dreyfus made a partial disclosure of the fraud allegations to Goldman, Sachs & Co., the purchaser of the debenture. None of the other four advisers to which Dirks relayed information about EFCA made any disclosure to purchasers of their EFCA securities.

On March 26, Dirks contacted the principals of Tomlin, Zimmerman & Parmelee ("TZP"), another registered adviser.[16] He revealed that several former employees claimed that EFCA had created fictitious insurance, assets and death certificates, and that top members of management were involved in the scheme. Although TZP had doubts as to the validity of Dirks' information, it immediately liquidated all of its clients' EFCA holdings, worth more than $487,000.

That same day, Dirks, responding to a telephone message, called the managing partner of Manning & Napier ("M&N"), another investment adviser. Dirks told the partner that, based on information from former EFCA employees, he had reason to believe that EFCA was writing bogus insurance. Shortly after Dirks' call, M&N liquidated all EFCA stock in its clients' accounts for about $90,000.

Also on March 26, Dirks was contacted by John W. Bristol & Co., Inc., a fifth investment adviser. Bristol had learned that Boston, its affiliate, was selling large amounts of EFCA securities based on information obtained from Dirks. It advised Dirks that its clients had substantial holdings of EFCA securities.[17] Dirks reported that several former employees of EFCA had told him that the company had substantial amounts of fictitious insurance on its books. He stated that "what he had heard was not good," that he expected an imminent halt in the trading of EFCA securities, and that, if he were in Bristol's position, "he would sell the stock." On that same day, Bristol sold all of its EFCA holdings for over $8 million.

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[16] TZP had originally contacted Dirks on March 20, after hearing that Boston had sold EFCA securities at a large loss.

[17] At the time, Bristol was in the process of adding 100,000 shares to its already large holdings of EFCA and had made a purchase only four days earlier. As recently as March 7, Bristol had extolled EFCA "as a unique growth company and superbly well run," and predicted that its "patient investors will receive their reward in due course."

On the same day, Dirks spoke to Blundell urging him to publicize the fraud charges. That evening, Dirks and Hopper met with Blundell for several hours for a further discussion of the matter. At Blundell's urging, Dirks and Hopper arranged to meet with members of the staff of our Los Angeles Regional Office on the following morning.

The New York Stock Exchange had been aware since March 22 of vague rumors concerning fraud at EFCA. It had monitored the substantial increase in the trading volume of EFCA securities and, on March 27, halted trading. On the following day, after obtaining information comparable to that acquired by Dirks during his inquiry, this Commission also suspended trading in EFCA securities.[18]

The first publicly available report of the EFCA fraud appeared on April 2 in a *Journal* article by Blundell. On April 5, EFCA filed a petition in bankruptcy. Subsequent investigations established that EFCA had perpetrated a massive fraud centered around the reinsurance of fictitious policies. EFCA had made bogus entries in its books since 1964 and, beginning in 1970, had manufactured increasing amounts of wholly fictitious insurance.[19]

III.

It is well established that corporate insiders who trade on the basis of material, non-public information, without first

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[18] A staff member of the Commission's Los Angeles Regional Office was indirectly notified of some elements of Secrist's allegations as early as March 8. However, it was not until March 27 that our staff received information concerning the full parameters of the fraud from Dirks and elicited testimony from some of the insiders with whom Dirks had spoken.

[19] Of more than $3 billion worth of life insurance ostensibly issued by EFCA, over $2 billion proved to be fictitious. More than $85 million in purported profits had been generated by the fraudulent scheme.

disclosing it, violate Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder.[20] "Tippees" of corporate insiders, who themselves trade, are equally liable.[21] Moreover, both corporate insiders and their "tippees" are liable for the trading violations of those whom they, in turn, "tip."[22] The dissemination of inside information to those who utilize it in dealing with uniformed public investors constitutes an act, practice, or course of conduct which operates as a fraud on investors. Even where the tipper does not himself engage in trading, he aids and abets the violation by providing the means by which the wrongful act occurs.

In this case, we are required to apply these principles to the activities of a securities analyst. Such individuals are in the business of formulating opinions and insights—not obvious to the general investing public—concerning the attractiveness of particular securities. In the course of their work, analysts actively seek out bits and pieces of corporate information not generally known to the market for the express purpose of analyzing that information and informing their clients who, in turn, can be expected to trade on the basis of the information conveyed. The value to the entire market of these efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by such initiatives to ferret out and analyze informa-

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[20] *See Chiarella* v. *United States*, 445 U.S. 222, 225-30 (1980); *S.E.C.* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 847-48 (2d Cir. 1968) (*en banc*), *cert. denied sub nom. Coates* v. *S.E.C.*, 394 U.S. 976 (1969); *Cady, Roberts & Co.*, 40 S.E.C. 907, 910-17 (1961). Where, as here, the securities transaction at issue is a sale, Section 17(a) of the Securities Act is also violated.

[21] *See Chiarella* v. *United States*, *supra*, 445 U.S. at 230 n.12; *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith*, 495 F.2d 228, 237-38 (2d Cir. 1974); *Faberge, Inc.*, 45 S.E.C. 249, 257 (1973).

[22] *See, e.g., Lilly* v. *State Teachers Retirement System*, 608 F.2d 55 (2d Cir. 1979), *cert. denied*, 100 S.Ct. 2159 (1980); *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 936-37 (1968).

tion, and thus the analyst's work redounds to the benefit of all investors.[23]

Despite the utility of the analyst's role, such professionals have no special license to ignore the insider trading proscriptions of the federal securities laws.[24] Those proscriptions are based on strongly held notions of public policy.[25] That policy, however, does not prohibit all trading based on informational advantages. Investors who engage in research and analysis may have an advantage over those who do not. Such an advantage is generally permissible.[26] However, because of the nature of their activities, analysts must be alert to the line between proper—even laudatory—analytical efforts and unlawful tipping. Where "tippees"—regardless of their motivation or occupation—come into possession of material "corporate information that they know is confidential and know or should know came from a corporate insider,"[27] they must either publicly disclose that information or refrain from trading. In addition, under aiding and abetting principles, a non-trading tipper

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[23] *See* Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 Harv. L. Rev. 322, 341 (1979).

[24] *See, e.g., Elkind* v. *Liggett & Myers, Inc.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 97,716 (2d Cir., December 4, 1980); *Lilly* v. *State Teachers Retirement System*, *supra*, 608 F.2d at 62; *S.E.C.* v. *Monarch Fund*, 608 F.2d 938, 941-43 (2d Cir. 1979); *S.E.C.* v. *Bausch & Lomb, Inc.*, 565 F.2d 8, 9-10, 14-15 (2d Cir. 1977); Fifth Annual Institute on Securities Regulation 276-82 (R. Mundheim, A. Fleischer, Jr. & J. Schupper eds. 1974).

[25] *See Elkind* v. *Liggett & Myers, Inc.*, *supra*, ¶ 97,716 at 98,755; *Chiarella* v. *United States*, *supra*, 445 U.S. at 225-30; *Cady, Roberts & Co.*, *supra*, 40 S.E.C. at 910-16.

[26] *See* Brudney, *supra*, 93 Harv. L. Rev. at 341.

[27] *Chiarella* v. *United States*, *supra*, 445 U.S. at 230 n.12.

is liable where he knew or should have known that his tippee would be likely to trade.[28]

Applying these general rules to the facts at hand, we find the evidence clear and convincing, as did the administrative law judge, that Dirks willfully disseminated material facts, which he knew were from inside corporate sources and were nonpublic, under circumstances where fraudulent sales of EFCA securities were reasonably likely to—and did—result.

A. Dirks points out that a violation based upon the transmission of inside information can only occur where the information in question constitutes "material facts." He argues that the information he furnished to those who sold EFCA securities was neither "factual" nor "material," but merely rumors and unverified allegations. We cannot agree.

We find that Secrist's report to Dirks on March 7 in and of itself constituted material information. This report from a former vice president of EFCA was about a massive fraud that went to the very heart of the company. Secrist's information had considerable objective indicia of reliability. It was specific and detailed. Furthermore, the package of information included within it the names of current and former insiders who Secrist said would corroborate and confirm the report. Indeed, based upon nothing more, Boston began to liquidate its holdings of EFCA.

Moreover, by March 23, the information which Dirks passed on to others was even more clearly material since by that time the corroboration and confirmation which Secrist said would be forthcoming had been obtained. By that afternoon, Dirks had elicited corroboration of Secrist's basic allegations, in whole or in part, from six present and former EFCA employees. Those

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[28] *See generally S.E.C.* v. *Coven*, 581 F.2d 1020, 1028 (2d Cir. 1978), *cert. denied*, 440 U.S. 950 (1979), *quoting S.E.C.* v. *Management Dynamics, Inc.*, 515 F.2d 801, 811 (2d Cir. 1975). *See also Elkind* v. *Liggett & Myers, Inc.*, *supra*, ¶ 97,716 at 98,754.

confirmations had, therefore, reinforced the basic allegations to such an extent that they had acquired an even stronger measure of probable validity and were clearly material.[29]

Accordingly, what Dirks disclosed to Dreyfus on March 23, and to three additional registered investment advisers on March 26, was far more than rumor and unverified allegations.[30] It was unquestionably material information. Although the existence of fraud at EFCA had not yet been proven as a matter of law, the corroborated information transmitted by Dirks to those tippees clearly constituted "facts" for purposes of the securities acts' antifraud provisions. Just as certain opinions, estimates, and predictions may be deemed "facts" regardless of whether they are ultimately proven correct, so may allegations of fraud become "facts" prior to being definitively established.[31]

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[29] *Cf. Elkind* v. *Liggett & Myers, Inc.*, *supra*, ¶ 97,216 at 98,753.

[30] Thus, we find inapposite those cases cited by Dirks where the depth and scope of the information available to the defendant was not comparable to that which Dirks received. In *Weiner* v. *Oppenheimer & Co.*, [1979] Fed. Sec. L. Rep. (CCH) ¶ 96,764 (S.D.N.Y., Feb. 5, 1979), and *Pachter* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 444 F. Supp. 417, 422 (E.D.N.Y. 1978), the courts held that the defendant broker-dealers were not obligated to disclose to purchasing customers the vague rumors circulating in the marketplace towards the end of March 1973 concerning fraud at EFCA. *Cf. Investors Management Co., Inc.*, 44 S.E.C. 633, 643 (1971).

[31] As one commentator has observed:

> "[T]he word 'fact' has a * * * [broad] meaning: It encompasses conclusions, intention and promises, opinions, recommendations to buy or sell a security, motive, estimates of a present or future event, projections and predictions of future occurrences, representations that an incident will take place and legal opinions." Jacobs, *The Impact of Rule 10b-5*, § 61.03 at 3-103 (Rev. ed. 1979) (footnotes omitted).

The basic test of materiality was set forth by the Supreme Court in *TSC Industries, Inc.* v. *Northway, Inc.*:

> "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to [act] * * *. Put another way there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[32]

We think it clear that the information disclosed by Dirks met the *Northway* test. It is almost axiomatic that, prior to buying EFCA securities, a reasonable investor would have deemed it

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[32] 426 U.S. 438, 449 (1976). *Accord, Harkavy* v. *Apparel Industries, Inc.*, 571 F.2d 737, 741 n.5 (2d Cir. 1978).

Dirks claims that the law judge improperly applied a composite test for materiality involving not only the *Northway* "reasonable investor" standard, but also the so-called "probability-magnitude" and "market impact" tests. The probability-magnitude test weighs the likelihood that an event will occur against its magnitude if it should occur. The market impact test weighs the actual impact on the market of disclosure of the information in question. These tests are, however, merely serviceable objective methods for making the factual determination mandated by *Northway*, and they have been regularly employed since *Texas Gulf Sulphur*. *Northway* did not disapprove these tests, and courts have continued to use them. *See, e.g., S.E.C.* v. *Mize*, 615 F.2d 1046, 1051, 1053 (5th Cir. 1980), *cert. denied*, ___ U.S. ___ (Oct. 14, 1980); *Lilly* v. *State Teachers Retirement System*, *supra*, 608 F.2d at 59; *Harkavy* v. *Apparel Industries Inc.*, *supra*, 571 F.2d at 741-42; *S.E.C.* v. *Bausch & Lomb, Inc.*, *supra*, 565 F.2d at 17-18; *S.E.C.* v. *Parklane Hosiery Co., Inc.*, 422 F. Supp. 477, 485 (S.D.N.Y. 1976), *aff'd*, 558 F.2d 1083, 1089 (2d Cir. 1977). We are cognizant of the fact that some investors whom Dirks informed chose not to sell their holdings in EFCA securities. Others, of course, did. We note, however, that, under the objective test enunciated in *Northway*, an actual transaction is a factor that we may, and in this case have, considered, but it is not dispositive of the issue of materiality.

important to know that, according to several present and former EFCA officials and employees, the company had engaged in a massive fraud which had substantially inflated its assets and earnings. Each of these insiders had provided Dirks with detailed, often first-hand information concerning the fraud. Few disclosures could have had a greater impact on the quality of an investment, or on the stability of the market for it, and Dirks and his tippees clearly appreciated that fact.[33] Whether or not each of the allegations was conclusively proven at that time is not determinative;[34] their existence, nature, detail, extent and repeated corroboration and confirmation rendered them material.

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[33] The fact that some tipped advisers "acted immediately or very shortly after receipt of the information to effect sales * * * is in itself evidence of its materiality." *Investors Management Co., Inc., supra*, 44 S.E.C. at 642. "Indeed, the manner in which the information was regarded by those privy to it and the importance attached to the information by the recipients after the 'tip' * * * were entirely consistent with a conclusion that the information was material information." *Lilly* v. *State Teachers Retirement System, supra*, 608 F.2d at 58, *citing S.E.C.* v. *Bausch & Lomb, Inc., supra*, 565 F.2d at 18. In addition, on March 19, when Dirks disclosed the fraud allegations to William Maloney, president of Institutional Capital Corp., an investment adviser, Maloney warned him that he could get into serious trouble by disclosing material, non-public information in such a fashion. The impact of the information being circulated, and of the ensuing sales, was also demonstrated by the rapid price decline of EFCA stock. Between Dirks' first contact with Secrist, and his March 26 disclosures less than three weeks later, the price of EFCA common stock dropped from $28 to $16 per share.

[34] *See Elkind* v. *Liggett & Myers, Inc., supra*, ¶ 97,716 at 98,753; *S.E.C.* v. *Geon Industries, Inc.*, 531 F.2d 39, 47-48 (2d Cir. 1976). The mere possibility of a substantial ore discovery based only on the visual evaluation of an initial drill core has been deemed a material fact. *See S.E.C.* v. *Texas Gulf Sulphur Co., supra*, 401 F.2d at 849-52. Other courts have held that "a forecast, essentially a prediction, may be regarded as a [material] 'fact' within the meaning of"

In this connection, it is important to recognize that this is not a case in which a skilled analyst weaves together a series of publicly available facts and non-material inside disclosures to form a "mosaic" which is only material after the bits and pieces are assembled into one picture. We have long recognized that an analyst may utilize non-public, inside information which in itself is immaterial in order to fill in "interstices in analysis."[35] That process is legitimate even though such "tidbits" of inside information "may assume heightened significance when woven by the skilled analyst into the matrix of knowledge obtained elsewhere," thereby creating material information.[36] But this is not such a case. Secrist's information certainly was not "seemingly inconsequential data."[37] Instead, its significance was immediately clear. Upon receipt of the information from Secrist, there was no need for Dirks to obtain, and he did not obtain, significant new facts to be woven together with Secrist's original allegations. All that occurred was corroboration and confirmation from inside sources of the original

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Rule 10b-5. *See Marx* v. *Computer Sciences Corporation*, 507 F.2d 485, 489 (9th Cir. 1974). *Accord* H. Kripke, *Rule 10b-5 Liability and "Material" "Facts,"* 46 N.Y.U.L. Rev. 1061, 1070 (1971).

Given the state of substantial uncertainty surrounding the prospects of EFCA as a result of the rumors which were then circulating, the interest of the reasonable investor in securing additional information became especially important.

> "The reasonable investor has an interest in knowing not only information which will, with reasonable certainty, affect the price of the stock he contemplates buying or selling. He also has an interest in obtaining information which renders it impossible to assess the value of his investment with any reasonable certainty and turns an otherwise reasonable investment into a speculative one." *Lilly* v. *State Teachers Retirement System, supra*, 608 F.2d at 60.

[35] *Investors Management Co., Inc., supra*, 44 S.E.C. at 646.

[36] *S.E.C.* v. *Bausch & Lomb, Inc., supra*, 565 F.2d at 9, 14.

[37] *See Elkind* v. *Liggett & Myers, supra*, ¶ 97,716 at 98,752.

allegations.[38] Under these circumstances, our decision here will not discourage analysts from engaging in the legitimate and desirable function of seeking out corporate information.

B. Dirks belatedly challenges the administrative law judge's finding that the sources of his information were "inside." In his post-argument supplemental memorandum concerning the *Chiarella* decision, Dirks argues that he did not acquire true inside information because none of the EFCA employees with whom he spoke had held higher than "mid-level" positions. Dirks also asserts that his sources cannot be considered insiders since the "true" insiders—top executives at EFCA—denied the allegations of fraud.

This argument is unavailing. Dirks does not challenge the propositions that his sources were present or former EFCA officials and employees, and that these persons had secured the information, which they were then divulging to him, in the course of their corporate duties. Dirks similarly does not deny that he was aware of these crucial facts. He cites no authority for the view that only the most senior corporate officials can constitute sources of material, inside information subject to the antifraud prohibitions. The purposes served by the insider trading proscriptions are just as compelling where the corporate informant who divulges confidential information is not of the highest rank, but "in a special relationship with a company and privy to its internal affairs."[39] It is clear that Dirks received material information from inside corporate sources, regardless

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[38] When asked whether any of the insiders he spoke with after Secrist made any new or additional allegations, Dirks responded, "I don't believe they added anything further to the allegations that Secrist had made, essentially."

[39] *Cady, Roberts & Co., supra*, 40 S.E.C. at 912.

of the fact that many of Dirks' informers were former employees when they spoke with Dirks.[40]

C. It is clear that Dirks knew that the information he obtained was confidential and non-public. In the first place, as noted immmediately above, Dirks received the information from inside corporate sources. From the nature of the information, the inference must have been obvious that his sources had received it during the course of their corporate duties, and that the company intended that it should be kept in confidence.[41] Nor does the fact that the information which was disclosed evidenced fraudulent, or even criminal, conduct alter its confidential nature *vis-a-vis* the private interests of Dirks and his tippees. It is one thing to relieve a corporate insider of his duty of confidentiality to the extent necessary to inform the proper authorities where improper or illegal conduct is taking place within the corporation. It is, however, quite another matter to allow the insider to profit by trading on the information himself—or to allow the insider's tippee to divulge it to those

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[40] *See S.E.C.* v. *Texas Gulf Sulphur Co., supra*, 401 F.2d at 848, 852-53, *a'ffg in pertinent part*, 258 F. Supp. 262, 279 (S.D.N.Y. 1967); *Ross* v. *Licht*, 263 F. Supp. 395, 409 (S.D.N.Y. 1967). *See also* Jacobs, *The Impact of Rule 10b-5* § 66.02(a) at 3-284 n.46 (Rev. ed. 1979); Restatement (Second) of Agency § 396, Comment b (1958); *Thomas* v. *Roblin Industries, Inc.*, 520 F.2d 1393, 1397 (3d Cir. 1975) (common law duty continues after termination of relationship); *Davidge* v. *White*, 377 F. Supp. 1084, 1089 (S.D.N.Y. 1974) (same).

[41] Thus, the present case is different from *S.E.C.* v. *Monarch Fund, supra*, where the court found no evidence that the defendant tippee-investment manager had any reason to believe that he had received confidential information in conversations with corporate insiders. Rather, the court determined that, "if any inference may be drawn, it is the contrary one * * *." *Id.* at 942. Moreover, unlike the highly detailed information that Dirks received from EFCA insiders, the information disclosed in *Monarch*, "by any standard, lacked the basic elements of specificity." *Id. See also Elkind* v. *Liggett & Myers, Inc., supra*, ¶ 97,716 at 98,753.

who may trade or tip traders.[42] Yet, Dirks engaged in precisely this kind of tipping.

Moreover, Dirks cannot have reasonably believed that the information which he received was public.[43] A distinction must

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[42] In tipping potential traders, Dirks breached a duty which he had assumed as a result of knowingly receiving confidential information from EFCA insiders. Tippees such as Dirks who receive non-public, material information from insiders become "subject to the same duty as [the] insiders." *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, *supra*, 495 F.2d at 237, *quoting Ross* v. *Licht*, *supra*, 263 F. Supp. at 410. *See also Investors Management Co.*, *supra*, 44 S.E.C. at 641. Such a tippee breaches the fiduciary duty which he assumes from the insider when the tippee knowingly transmits the information to someone who will probably trade on the basis thereof. *See Chiarella* v. *United States*, *supra*, 445 U.S. at 230 n.12. *See also Elkind* v. *Liggett & Myers, Inc.*, *supra*, ¶ 97,716 at 98,754. Presumably, Dirks' informants were entitled to disclose the EFCA fraud in order to bring it to light and its perpetrators to justice. However, Dirks—standing in their shoes—committed a breach of the fiduciary duty which he had assumed in dealing with them, when he passed the information on to traders.

[43] Nor can Dirks reasonably contend that he himself made this information public by virtue of his disclosures, on an individual basis, to all those who inquired of him. Assuming *arguendo* that Dirks did divulge his information to anyone who inquired, his continuing effort to secure disclosure in *The Wall Street Journal* underscores his realization that his own tips to a small circle of interested persons did not render the inside information public. As we have previously said:

> "[P]ublic dissemination of information * * * cannot be accomplished by disclosure to or through a favored analyst or group of analysts. On the contrary, this facilitates improper use of non-public information. Proper and adequate disclosure of significant corporate developments can only be effected by public release through the appropriate public media, designed to achieve a broad dissemination to the investing public generally and without favoring any special person or group." *Faberge, Inc.*, *supra*, 45 S.E.C. at 255-56.

See also S.E.C. v. *Texas Gulf Sulphur Co.*, *supra*, 401 F.2d at 854; *Investors Management Co.*, *supra*, 44 S.E.C. at 643.

be drawn between the vague public rumors which were then circulating concerning EFCA, and the clearly non-public, explicit inside information which Dirks elicited from several present and former employees of EFCA. Were there any doubt on this point, Dirks' extensive efforts to verify the information, and the skepticism of some of the individuals whom Dirks tipped, should have made clear to him that it was not otherwise generally available. Accordingly, we conclude that the report that much of EFCA's insurance business was fictitious was not "public" until April 2.

D. Finally, Dirks knew or should have known that, in discussing with certain investment advisers the material, nonpublic information which he had received, there was a strong probability that trading would result. This point does not require extended analysis. The inside information to which Dirks had become privy demonstrated, in the words of one commentary, that "one of the darlings of Wall Street, a company that had managed to produce continued high earnings growth for a decade, * * * was, instead, a gigantic fraud."[44] Under the circumstances, it took little insight into the operations of the market—and Dirks was, of course, a highly experienced and highly sophisticated analyst—to recognize that anyone who held EFCA shares and became aware of the information in Dirks' possession would have a strong incentive to sell before that knowledge became widespread. Indeed, Dirks expressly advised at least one of those whom he tipped to sell, and he observed that others did so, even without an explicit recommendation, based on his revelations.[45] Accordingly, we find that Dirks knew or should have known that his selective disclosure of the information he had gleaned from EFCA insiders would result in trading.

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[44] L. Seidler, F. Andrews, and M. Epstein, *The Equity Funding Papers* vii (1977).

[45] This point is discussed in greater detail in Part E, *infra*.

E. Dirks further argues that, even if he engaged in the dissemination to likely traders of material, inside information, we must also find that he acted with scienter within the meaning of *Ernst & Ernst* v. *Hochfelder*.[46] We think it clear that Dirks did act with the requisite scienter.[47]

Before any public disclosure had been made, Dirks relayed the information he had received to investment advisers who he knew had an interest in or held EFCA securities. Dirks had extensive experience with the securities markets; he must have realized the trading advantage he was imparting and its potential impact. Moreover, the record indicates that Dirks clearly expected many of his tippees to liquidate their EFCA securities following his disclosures. In fact, he explicitly

---

[46] 425 U.S. 185 (1976).

[47] Dirks asserts that he was "basically * * * indifferent" to the effect of his disclosures. We think it clear that such reckless disregard for the possible consequences of one's actions constitutes scienter within the meaning of *Hochfelder*. Reckless conduct has been held sufficient to satisfy the scienter requirement. *See, e.g., Edward J. Mawod & Co.* v. *S.E.C.*, 591 F.2d 588, 595-597 (10th Cir. 1979); *Mansbach* v. *Prescott, Ball & Turben*, 598 F.2d 1017, 1023-1025 (6th Cir. 1979); *Nelson* v. *Serwold*, 576 F.2d 1332, 1337-38 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978). The Supreme Court has twice expressly reserved judgment on this issue. *Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 193 n.12; *Aaron* v. *S.E.C.*, 100 S. Ct. 1945, 1950 n.5. Similarly, there is no support for Dirks' argument that recklessness does not suffice when applied to an aider and abettor. *Woodward* v. *Metro Bank of Dallas*, 522 F.2d 84, 97 (4th Cir. 1975), does state, as noted by Dirks, that "an alleged aider-abettor should be found liable only if scienter of the high 'conscious intent' variety can be proved." However, the court was referring only to situations where the alleged aider and abettor played a completely passive role in the asserted misconduct. Dirks' role was anything but passive.

advised Bristol to sell its holdings and implied as much to others.[48]

As early as March 15, Dirks had a specific illustration of the effect his disclosures could produce. On March 14, he had called John Buszin of Bankers Trust Company after learning that the bank held EFCA securities. At a meeting the next day, Dirks' recitation of the fraud allegations was interrupted by Buszin who stated that he had heard enough and would liquidate Bankers' holdings of EFCA.[49] Dirks testified that he was "shocked" by such a quick decision to sell. However, any remaining doubts Dirks may have had as to the impact of the information he was imparting should have been dispelled when he learned on March 21 that Boston was going to liquidate its clients' entire remaining holdings of EFCA.[50]

* * *

In sum, Dirks came into possession of material, non-public corporate information, from persons who he knew were in-

---

[48] As one court has recently held, "[O]ne who deliberately tips information which he knows to be material and non-public to an outsider who may reasonably be expected to use it to his advantage has the requisite scienter." *Elkind* v. *Liggett & Myers, Inc.*, ¶ 97,716 at 98,754 (footnotes omitted).

[49] Bankers Trust is not subject to the Commission's administrative jurisdiction and was not a respondent in this action.

[50] Dirks further argues that he relied on advice of counsel. However, the record does not support this claim. On March 19, Dirks had a brief discussion concerning his inquiry with an attorney he encountered by chance at Delafield's offices. But Dirks neither sought nor received any legal advice. Dirks also claims that he relied on advice which he received two days later from a vice president of Boston. However, the vice president was not an attorney. While he told Dirks that he had consulted with counsel, Dirks had no such consultation. Moreover, Dirks did not know what counsel had been told. In fact, the attorney in question had only been provided with sketchy information concerning Secrist's initial allegations.

siders, at a time when he knew that the information was confidential and not then publicly available. He communicated that information to those likely to trade before the information became generally available. In committing these acts, Dirks acted with scienter. Accordingly, we conclude that Dirks willfully aided and abetted violations by Boston, Dreyfus, TZP, M&N and Bristol of Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder.[51]

Dirks contends that the sanction imposed by the administrative law judge is too severe. For its part, the Division of Enforcement seeks an increase in the 60-day suspension which Dirks received. In addition, Dirks asserts that the levying of any sanction against him will serve to discourage investors and securities analysts from actively researching corporations and, especially, investigating allegations of fraud.

We fully appreciate the importance of the analyst's work in providing public investors with an accurate and complete factual basis upon which to make their investment decisions. Accordingly, we do not seek in any way to chill the investigation of rumors concerning a particular company. Nonetheless, the analyst's role, like that of any other person, is constrained by the well-established proscriptions of the antifraud provisions of the federal securities laws, and we cannot condone the unfairness inherent in the selective dissemination of material,

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[51] In *Aaron* v. *S.E.C.*, *supra*, 100 S. Ct. at 1956-57, the Supreme Court held that violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act do not require proof of scienter. And all of our findings against Dirks are made under both those sections. Our findings that Dirks also aided and abetted violations of Section 17(a)(1) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder are merely cumulative, and the sanction we are imposing would be the same even if we had made no findings under those provisions. Thus, while we think it clear that Dirks acted with scienter, that finding is not determinative.

inside information prior to its public disclosure.[52] Neither the analysis set forth above, nor the sanction we impose, should hamper legitimate, investigative securities analysis.

Nevertheless, we have concluded that the administrative law judge's sanction should be reduced. It is clear that Dirks played an important role in bringing EFCA's massive fraud to light, and it is also true that he reported the fraud allegations to EFCA's auditors and sought to have the information published in *The Wall Street Journal*. Moreover, it appears that most of his contacts with investment advisers were initiated by them, rather than by Dirks, and, as noted above,[53] none of the five registered investment advisers whose trading violations were aided and abetted by Dirks' tipping received more than a censure. Finally, Dirks' otherwise unblemished 20-year record in the securities industry also weighs heavily in the balance. Under all the circumstances, we conclude that the imposition of censure will adequately serve the public interest in this case.[54]

An appropriate order will issue.[55]

---

[52] Dirks points to his efforts to contact *The Wall Street Journal*. At the same time, however, he continued to communicate his findings to investment advisers who he knew or should have known might trade on the information well before it would become public.

[53] *See* n.1, *supra*.

[54] The sanction we are imposing would be the same even if we had not found that Dirks aided and abetted Boston's violations of anti-fraud provisions.

[55] Dirks' exceptions are overruled or sustained to the extent that they are inconsistent or in accord with the views expressed in this opinion.

By the Commission (Chairman WILLIAMS and Commissioners LOOMIS and EVANS); Commissioners FRIEDMAN and THOMAS, not participating.

George A. Fitzsimmons
GEORGE A. FITZSIMMONS
Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 17480/January 22, 1981

Admin. Proc. File No. 3-5068

In the Matter of

RAYMOND L. DIRKS
50-1/2 Barrow Street
New York, New York

ORDER IMPOSING REMEDIAL SANCTION

On the basis of the Commission's opinion issued this day, it is ORDERED that Raymond L. Dirks be, and he hereby is, censured.

By the Commission.

George A. Fitzsimmons
GEORGE A. FITZSIMMONS
Secretary

APPENDIX C

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 81-1243

RAYMOND L. DIRKS, *Petitioner*

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent*

[No Opinion]
SEPTEMBER TERM, 1981

No. 3-5068

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

FILED
MAR 29 1982

George A. Fisher
Clerk

Petition for Review of an Order of the Securities and Exchange Commission.

Before WRIGHT, TAMM, and ROBB, Circuit Judges.

JUDGMENT

This cause came on to be heard on a petition for review of an order of the Securities and Exchange Commission and was briefed and argued by counsel. The issues presented have been accorded full consideration by the court; they occasion no need for an opinion. *See* Local Rule 13(c).

The record in this case fully supports the Commission's findings that petitioner breached his duty to the Commission

and to the public not to misuse insider information and that he was compensated for so doing. The record also assures us that the other findings of the Commission are not clearly erroneous and that the Commission's conclusions are solidly based in the law.

On consideration of the foregoing, it is ORDERED and ADJUDGED by this court that, for the reasons stated by the Commission in its opinion, the order sought to be reviewed herein is hereby affirmed.

Per Curiam
For the Court

George A. Fisher
GEORGE A. FISHER
Clerk

Circuit Judge TAMM dissents from the foregoing judgment.

C-3

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 81-1243

RAYMOND L. DIRKS, *Petitioner*

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent*

SEPTEMBER TERM, 1981

Argued 1-7-82

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

FILED
MAY 19 1982

George A. Fisher
Clerk

Before WRIGHT, TAMM, and ROBB, Circuit Judges.

O R D E R

On consideration of petitioner's petition for rehearing, filed April 27, 1982, it is

ORDERED by the Court that the aforesaid petition is denied.

Per Curiam

FOR THE COURT:
George A. Fisher
Clerk

BY: Robert A. Bonner
ROBERT A. BONNER
Chief Deputy Clerk

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 81-1243

RAYMOND L. DIRKS, *Petitioner*

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent*

SEPTEMBER TERM, 1981

Argued 1-7-82

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

FILED
MAY 19 1982

George A. Fisher
Clerk

BEFORE: ROBINSON, Chief Judge; WRIGHT, TAMM, MACKINNON, ROBB, WILKEY, WALD, MIKVA, EDWARDS, GINSBURG and BORK, Circuit Judges.

ORDER

Petitioner's suggestion for rehearing *en banc* has been circulated to the full Court and no member of the Court has requested the taking of a vote thereon. On consideration of the foregoing, it is

ORDERED by the Court *en banc* that the aforesaid suggestion is denied.

Per Curiam

FOR THE COURT:

George A. Fisher,
Clerk

BY: Robert A. Bonner
ROBERT A. BONNER
Chief Deputy Clerk

Circuit Judges MacKinnon, Wald and Mikva did not participate in the foregoing order.

APPENDIX D

STATUTORY AND REGULATORY APPENDIX

Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a):

> (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b):

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate

commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Office - Supreme Court, U.S.
FILED
DEC 20 1962
ALEXANDER L. STEVAS,
CLERK

No. 69-276

IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

RAYMOND L. DIRKS,

Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The District Of Columbia Circuit

JOINT APPENDIX

DAVID ROSENBERGER
Counsel of Record
LAWRENCE A. SCHNEIDER
ERIC SUSSMAN
ARNOLD & PORTER
1200 New Hampshire Avenue, N.W.
Washington, D.C. 20036
(202) 872-6700
Attorneys for Petitioner
Raymond L. Dirks

PAUL GONSON
Solicitor
Counsel of Record
LARRY R. LAVOIE
Senior Special Counsel
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
(202) 272-2476
Attorneys for Respondent
Securities and Exchange Commission

PETITION FOR CERTIORARI FILED AUGUST 17, 1962
CERTIORARI GRANTED NOVEMBER 15, 1962

PRESS OF BYRON S. ADAMS PRINTING, INC., WASHINGTON, D.C.

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These following items are contained in the Appendix to the Petition for a Writ of Certiorari and are incorporated in the Joint Appendix by reference:

OPINION AND ORDER OF THE SECURITIES AND EXCHANGE COMMISSION, DATED JANUARY 22, 1981

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OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT, DATED MAY 18, 1982

ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT DENYING PETITION FOR REHEARING, DATED MAY 19, 1982

ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT DENYING REHEARING *EN BANC*, DATED MAY 19, 1982

LIST OF RELEVANT HEARINGS HELD, PLEADINGS FILED, AND ORDERS ENTERED BY AND BEFORE THE SECURITIES AND EXCHANGE COMMISSION

(*In Re* The Boston Company Institutional Investors, Inc., John W. Bristol & Co., Inc., Raymond L. Dirks, The Dreyfus Corporation, Manning & Napier, and Tomlin, Zimmerman & Parmelee, Inc. Administrative Proceeding No. 3-5068)

August 24, 1976 Order for public proceedings before the Securities and Exchange Commission filed

September 10, 1976 Order amending Order for public proceedings to add Dreyfus Corp. as a respondent entered

October 8, 1976 Answer of Respondent Dirks filed

December 2, 1976; January 31-February 4, 1977; February 7-9, 15-17, 22-24, and 28, 1977; March 2, 9-10, 14-17, 21, 24, and 29-31, 1977; April 1, 1977; June 27-July 1, 1977; July 11-15, 18-21, 25-26, and 28, 1977; August 22-24 and 29-31, 1977; September 1, 2, and 6, 1977 Hearings Before Administrative Law Judge David Markun

March 28, 1977 Statement of the Division of Enforcement's theories of law filed

November 25, 1977 Proposed Findings of Fact and Conclusions of Law of the Division of Enforcement filed

November 25, 1977 Memorandum of the Division of Enforcement in support of its Proposed Findings and Conclusions filed

March 15, 1978 Respondents' Joint Proposed Findings of Fact and Conclusions of Law filed

March 15, 1978 Proposed Findings of Fact, Conclusions of Law and Objections of Respondent Dirks filed

March 16, 1978 Memorandum of Law for Respondent Dirks filed

March 17, 1978 Respondents' Joint Memorandum in Support of their Proposed Findings of Fact and Conclusions of Law filed

April 12, 1978 Notice of supplemental authority of Respondent Dirks filed

April 21, 1978 Respondent Dirks' Supplemental Memorandum on the issue of sanctions filed

May 22, 1978 Reply Memorandum of the Division of Enforcement filed

May 22, 1978 Objections to Respondents' Proposed Findings of Fact and replies to Respondents' Objections to Division's Proposed Findings of Fact filed by the Division of Enforcement

June 14, 1978 Letter to Judge Markun from Donald Malawsky of the Division of Enforcement concerning recent court decisions

June 26, 1978 Letter to Judge Markun from Messrs. Bonderman and Hird, counsel for Respondent Dirks, concerning recent court decisions

September 1, 1978 Initial Decision of Judge Markun entered

October 2, 1978 Respondent Dirks' Petition for review by the Commission filed

October 12, 1978 Order granting Petitions for review filed by Respondent Dirks and the Division of Enforcement entered

October 17, 1978 Order giving notice that the Initial Decision of the Administrative Law Judge became final as to all Respondents other than Respondent Dirks entered

November 20, 1978 Memorandum in support of the Division of Enforcement's Petition for Review filed

January 3, 1979 Memorandum in support of Respondent Dirks' Petition for Review and in Opposition to the Division's Petition filed

March 6, 1979 Reply Memorandum of the Division of Enforcement filed

April 6, 1979 Reply Memorandum of Respondent Dirks filed

June 13, 1979 Oral Argument Before Securities and Exchange Commission

May 30, 1980 Notice of supplemental authority of Respondent Dirks filed

June 11, 1980 Reply of the Division of Enforcement to Respondent Dirks' Notice of supplemental authority filed

June 26, 1980 Second Notice of supplemental authority of Respondent Dirks filed

June 26, 1980 Response of Respondent Dirks to reply to the Notice of supplemental authority filed

July 8, 1980 Reply of the Division of Enforcement to Respondent Dirks' second Notice of supplemental authority filed

August 7, 1980 Response to Division's reply to Dirks' second Notice of supplemental authority filed

January 22, 1981 Opinion and Order of the Commission censuring Respondent Dirks entered

February 10, 1981 Application of Respondent Dirks for stay of Order pending appeal filed

February 11, 1981 Order staying imposition of censure pending appeal entered

February 23, 1981 Memorandum of Law of the Division of Enforcement in Opposition to Respondent Dirks' Motion for a Stay filed

RELEVANT DOCKET ENTRIES IN THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

(Raymond L. Dirks v. Securities and Exchange Commission, No. 80-1243)

DATE	FILINGS — PROCEEDINGS
(V)03-05-81	4-Petitioner's petition for review of an order of the SEC (m-5)
(T)04-27-81	Certified Index to Record (n-2)
(V)07-10-81	4-Petitioner's brief (p-10)
(V)09-09-81	4-Respondent's brief (m-1)
(V)10-06-81	3-Petitioner's reply brief (p-6)
(V)10-06-81	7-Joint appendix - volumes I & II (p-6)
(V)11-02-81	15-Respondent's brief (m-20); withdrawn per 12/15/81 order
(C)12-15-81	15-SEC's corrected brief (m-24)
(B)01-07-82	Argued before Wright, Tamm and Robb, CJs
(C)01-27-82	4-Letter from counsel for SEC advising of additional authorities pursuant to FRAP 28(j) (m-27)
(V)02-03-82	4-Letter from counsel for petitioner advising of additional authorities pursuant to FRAP 28(j) (m-3)
(V)02-17-82	4-Letter from counsel for petitioner advising of additional authorities pursuant to FRAP 28(j) (m-16)
(V)03-09-82	4-Letter from counsel for SEC in response to petitioner's letter pursuant to FRAP 28(j) (m-4) (OK,RAB)
(S)03-29-82	Judgment that the order of the SEC is affirmed; no opinion or memo

DATE	FILINGS—PROCEEDINGS

(C)04-27-82 15-Petitioner's petition for rehearing and suggestion for rehearing en banc (m-27)

(S)05-18-82 Opinion for the Court filed by CJ Wright

(S)05-18-82 Standard order on mandate

(V)05-19-82 Per Curiam order, en banc, that petitioner's suggestion for rehearing en banc is denied; CJ Robinson, Wright, Tamm, MacKinnon, Robb, Wilkey, Wald, Mikva, Edwards, Ginsburg and Bork, CJs (MacKinnon, Wald and Mikva, CJs did not participate in the foregoing order)

(V)05-19-82 Per Curiam order that petitioner's petition for rehearing filed April 27, 1982 is denied; Wright, Tamm and Robb, CJs

(S)05-26-82 Certified copy of judgment and of opinion issued to SEC

(C)08-20-82 Notice from Clerk, SC that petition for writ of certiorari was filed in SC No. 82-276 on Aug. 17, 1982

(T)11-16-82 Certified copy of order from Clerk, Supreme Court granting petition for writ of certiorari in SC No. 82-276 on 11-15-82

ADMINISTRATIVE PROCEEDING
FILE NO. 3-5068

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

August 24, 1976

In the Matter of

BOSTON COMPANY INSTITUTIONAL
INVESTORS, INC.
(801-6829)

JOHN W. BRISTOL & CO., INC.
(801-4726)

RAYMOND L. DIRKS

DREYFUS SPECIAL INCOME FUND, INC.
(811-2209)

MANNING & NAPIER
(801-6611)

TOMLIN, ZIMMERMAN & PARMELEE, INC.
(801-8853)

ORDER FOR PUBLIC PROCEEDINGS PURSUANT TO SECTION 15(b) AND 19(h) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 203(e) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940

I

The Commission's public official files disclose that:

A. The Boston Company Institutional Investors, Inc. ("III") has, at all times since August 24, 1970, been registered

with the Commission as an investment adviser. III's principal place of business is One Boston Place, Boston, Massachusetts 02108.

B. John W. Bristol & Co., Inc. ("Bristol Co.") has, at all times since February 28, 1968, been registered with the Commission as an investment adviser. Bristol Co.'s principal place of business is 233 Broadway, New York, New York 10007.

C. The Dreyfus Special Income Fund, Inc. ("Dreyfus") has, at all times since July 1971, been registered with the Commission as an investment company. Its principal place of business is 767 Fifth Avenue, New York, New York 10022.

D. Manning & Napier has, at all times since May of 1970, been registered with the Commission as an investment adviser. Its principal place of business is One East Avenue, Rochester, New York 14604.

E. Tomlin, Zimmerman & Parmelee, Inc. ("TZP") has, at all times since September 1972, been registered with the Commission as an investment adviser. TZP's principal place of business is 1133 Avenue of the Americas, New York, New York 10036.

II

As the result of an investigation ordered by the Commission, the Division of Enforcement alleges that:

A. In March of 1973 Raymond L. Dirks ("Dirks") was a security analyst specializing in the insurance industry. At that time, Dirks was associated with a broker-dealer registered with the Commission and a member of the New York Stock Exchange ("NYSE") and other national exchanges. He is currently employed in the securities industry.

B. From 1960 to 1966 Equity Funding Corporation of America ("Equity Funding") was essentially a marketing organization selling life insurance, shares in mutual funds, and funding programs combining the two. In 1967 Equity Funding embarked on a diversification program which included the

acquisition of various companies, and by 1970 Equity Funding's subsidiaries were engaged in a variety of business enterprises that included mutual funds, insurance companies, marketing companies, a savings and loan association, certain foreign operations, partnerships in oil and gas exploration and cattle breeding, and a real estate development enterprise.

C. Equity Funding first issued its securities to the public in 1964. Pursuant to a registration statement filed with the Commission, 100,000 common shares were offered and sold at $6 per share.

D. In 1965 Equity Funding issued $2,000,000 of 5½% capital subordinated notes due in 1980 with common stock purchase warrants, pursuant to a registration statement filed with the Commission.

E. In 1967 Equity Funding issued $6,000,000 of 5½% convertible debentures due in 1982, pursuant to a registration statement filed with the Commission.

F. In 1968 Equity Funding issued $15,000,000 of 5½% convertible subordinated debentures due in 1983, pursuant to a registration statement filed with the Commission.

G. In 1970 Equity Funding issued $22,000,000 of 9½% debentures due in 1990, with common stock purchase warrants, pursuant to a registration statement filed with the Commission.

H. In 1971 Equity Funding issued $38,000,000 of 5½% convertible subordinated debentures due in 1991, pursuant to a registration statement filed with the Commission.

I. From 1964 to about March 1973, Equity Funding filed periodic reports with the Commission pursuant to the Exchange Act.

J. During March of 1973 and prior thereto, Equity Funding common shares and the 5½% convertible subordinated debentures due in 1991 ("the debentures") were listed and traded on the NYSE. Equity Funding warrants were listed and traded on the American Stock Exchange.

K. For the week ending March 9, 1973, Equity Funding common shares traded on the NYSE at a high of $28⅜ and a low of $25⅝, with average daily volume of 9,860 shares, closing at $28. For the same week, the debentures traded at a high of $91 and a low of $89½, on average daily volume of 17 bonds. From March 12, 1973 to March 27, 1973, Equity Funding's common stock and debentures were traded on the NYSE approximately as follows:

EQUITY FUNDING CORP. OF AMERICA

COMMON SHARES DAILY TRADING

Date	Low	High	Volume
3-12-73	27½	28⅜	33,700
3-13-73	27¼	27⅝	14,300
3-14-73	27	27⅜	15,000
3-15-73	25½	26⅞	45,300
3-16-73	25	25⅝	10,700
3-19-73	23	25	123,800
3-20-73	23⅛	23½	14,400
3-21-73	19¼	23⅛	524,000
3-22-73	19¾	20¼	59,600
3-23-73	18⅞	20¼	113,700
3-26-73	16⅝	19¾	768,400
3-27-73	14⅜	17½	307,200

(trading suspended 3-27-73)

5½ CONVERTIBLE SUBORDINATED DEBENTURES 1991

WEEKLY TRADING

Week Ending	Low	High	Volume
3-16-73	90	93	114
3-23-73	75	85	273
3-30-73	67	75⅛	552

(trading suspended 3-27-73)

L. At or about 12:45 p.m. on March 27, 1973, the New York Stock Exchange suspended trading in Equity Funding securities.

M. On March 28, 1973 the Commission suspended all trading in the securities of Equity Funding.

N. On April 2, 1973, the Commission filed a civil injunctive action in the United States District Court, Central District of California, against Equity Funding, alleging violations of the antifraud and reporting provisions of the Exchange Act and rules thereunder. On April 3, 1973, a judgment of permanent injunction on consent was entered against Equity Funding.

O. On April 5, 1973 Equity Funding filed a petition under Chapter X of the Bankruptcy Act which was approved by the U.S. District Court on April 6, 1973, effective April 5, 1973. On or about April 10, 1973, that court appointed a trustee for Equity Funding.

P. After conducting an investigation, the trustee reported to the court that from on or about 1964 to and including March 1973, Equity Funding and its management conspired to commit and did commit numerous fraudulent acts and practices, including but not limited to the creation and inflation of assets and earnings reflected in Equity Funding's financial statements; the creation of bogus insurance policies which were co-insured with other insurance companies; and the creation and maintenance of false and fraudulent business records. The effect of these acts and practices was to inflate Equity Funding's earnings and assets and to create a false and misleading appearance of sustained growth by Equity Funding as reflected in various periodic reports filed by the company with the Commission, and in reports to its shareholders.

Q. On November 1, 1973 a Federal Grand Jury in Los Angeles, California returned a 105-count indictment in connection with the Equity Funding matter against 22 persons, including certain of Equity Funding's officers and directors, for conspiracy to commit certain federal violations, including violations of the antifraud provisions of the federal securities

laws, filing fraudulent registration statements under the Securities Act of 1933, filing fraudulent reports under the Securities Exchange Act of 1934, mail fraud, bank fraud, interstate transportation of counterfeit securities, interstate transportation of securities taken by fraud and electronic eavesdropping. The defendants were charged with various substantive counts for offenses which were the object of the conspiracy. These proceedings have been concluded by the entry of guilty pleas or the conviction after trial of all defendants for one or more of the counts against them.

R. From on or about March 6, 1973 to and including March 27, 1973, respondents Dirks, III, Bristol Co., Dreyfus, Manning & Napier and TZP, directly and indirectly, wilfully violated and wilfully aided and abetted violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; that in connection with the purchase and sale of Equity Funding securities, they, directly and indirectly, employed devices, schemes, and artifices to defraud, obtained money and property by means of untrue statements of material facts, and omissions to state material facts necessary in order to make the statements made in the light of the circumstances in which they were made, not misleading, and engaged in transactions, acts and practices and a course of business which would and did operate as a fraud and deceit upon the purchasers and prospective purchasers of such securities; in that:

1. From on or about March 6, 1973, to and including March 27, 1973, Dirks acquired material nonpublic information concerning the affairs and business of Equity Funding, including, but not limited to, information

(a) that Equity Funding had issued and was carrying on its books and records fictitious life insurance policies and supporting records relating to such policies;

(b) that Equity Funding had been carrying on its books and records fictitious assets and earnings;

(c) that Equity Funding had publicly issued false and fraudulent statements of insurance premium income;

(d) that Equity Funding had publicly issued false and fraudulent financial statements; and

(e) that officers and employees of Equity Funding had engaged in the fraudulent schemes and courses of conduct as set forth in subparagraphs (a) through (d) above.

2. From on or about March 12, 1973, to and including March 27, 1973, while respondents III, Bristol Co., Dreyfus, Manning & Napier and TZP ("selling respondents") were in possession of material, non public information conveyed to them by respondent Dirks, which information is set forth in paragraph 1 above, such selling respondents sold or caused to be sold Equity Funding securities for their accounts or from the accounts of others without disclosing such information to the purchasers of the Equity Funding securities sold or caused to be sold by the selling respondents.

3. From on or about March 12, 1973, to and including March 21, 1973, Dirks conveyed the information set forth in paragraph 1 above to III.

4. On March 15, 1973, III sold for its clients 36,500 Equity Funding common shares for net proceeds of about $942,795. On March 16, III sold for its clients $300,000 face value of the debentures for net proceeds of about $260,133. On or about March 21, 1973, III sold on behalf of clients 371,500 Equity Funding common shares and $575,000 face value of the debentures for net proceeds of about $7,117,157 and about $436,[illegible], respectively.

5. On or about March 26, 1973, Dirks conveyed the information set forth in paragraph 1 above to TZP, which on March 26, 1973 sold for clients approximately 24,920 Equity Funding common shares for proceeds of approximately $428,028, and $60,000 face value of the debentures for net proceeds of about $43,382.

6. From on or about March 23, to and including March 26, 1973, Dirks conveyed the information set forth in paragraph 1

above to Dreyfus, which, on March 26, 1973, sold for its own account $500,000 face value of the debentures for net proceeds of approximately $362,993.

7. On or about March 26, 1973 Dirks conveyed the information set forth in paragraph 1 above to Bristol Co., which immediately thereafter sold for its clients approximately 457,200 Equity Funding common shares for net proceeds of approximately $7,929,134, and $200,000 face value of the debentures for net proceeds of approximately $152,697; and the Bristol Employees Plan sold 600 Equity Funding common shares for net proceeds of approximately $10,399.

8. On March 26, 1973 Dirks conveyed the information in paragraph 1 above to Manning & Napier, which on March 26, 1973 sold about 5,450 Equity Funding common shares for its clients for net proceeds of approximately $89,922.

9. From on or about March 15, 1973 to on or about March 27, 1973 Dirks conveyed the information in paragraph 1 above to other large shareholders of Equity Funding securities, which shareholders are not registered with the Commission. From on or about March 15, 1973 to on or about March 27, 1973 these shareholders sold Equity Funding securities for proceeds of approximately $8,900,000.

S. As a result of the activities described above, the respondents violated and aided and abetted violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder.

T. While engaged in the acts and practices described above, Dirks and the selling respondents, directly and indirectly, used or caused to be used the mails and means and instruments, and instrumentalities of transportation and communication in interstate commerce and the facilities of a national securities exchange.

III

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate in the public interest and for the protection of investors, that public proceedings be instituted to determine:

A. Whether the allegations set forth in Section II hereof are true and in connection therewith to afford the respondents an opportunity to establish any defenses to such allegations.

B. What, if any, remedial action is appropriate in the public interest, pursuant to Sections 15(b) and 19(h) of the Securities Exchange Act of 1934, Sections 203(e) of the Investment Advisers Act of 1940 and 9(b) of the Investment Company Act of 1940.

IV

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof be held at a time and place to be set, and before an Administrative Law Judge to be designated by further order of the Commission, as provided by Rule 6 of the Commission's Rules of Practice.

IT IS FURTHER ORDERED that the respondents file an answer to the allegations contained in this order for proceedings within 15 days after service upon them of said order, as provided by Rule 7 of the Commission's Rules of Practice.

If any party fails to file the directed answer, or fails to appear at a hearing after being duly notified, such party shall be deemed in default and the proceedings may be determined against such party upon consideration of this order for proceedings, the allegations of which may be deemed to be true.

This order shall be served upon the respondents personally or by certified mail forthwith.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of in-

vestigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision upon this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 4(c) of the Administrative Procedure Act, it is not deemed subject to the provisions of that Section, delaying the effective date of any final Commission action.

By the Commission.

George A. Fitzsimmons
Secretary

/s/ SHIRLEY E. HOLLIS
By: Shirley E. Hollis
Assistant Secretary

ADMINISTRATIVE PROCEEDING
FILE NO. 3-5068

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

September 10, 1976

In the Matter of

BOSTON COMPANY INSTITUTIONAL INVESTORS, INC.
(801-6829)

JOHN W. BRISTOL & CO., INC.
(801-4726)

RAYMOND L. DIRKS

THE DREYFUS CORPORATION
(801-8147)

MANNING & NAPIER
(801-6611)

TOMLIN, ZIMMERMAN & PARMELEE, INC.
(801-8853)

ORDER AMENDING ORDER FOR PUBLIC PROCEEDINGS PURSUANT TO SECTION 15(b) AND 19(h) OF THE SECURITIES EXCHANGE ACT OF 1934, SECTION 203(e) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940

I.

The Commission, having by order dated August 24, 1976, instituted public proceedings pursuant to Section 15(b) of the Securities Exchange Act of 1934, Section 203(e) of the Invest-

ment Advisers Act of 1940 and Section 9(b) of the Investment Company Act of 1940 in the matter of Boston Company Institutional Investors, Inc., *et al.*, and the Commission having duly considered the matter and having determined it to be in the public interest,

HEREBY ORDERS pursuant to Rule 6 of the Commission's Rules of Practice that said Order for Public Proceedings be amended as follows:

Paragraph C of Section I shall be amended and shall read as follows:

> C. The Dreyfus Corporation ("Dreyfus") has at all times since December 10, 1971 been registered with the Commission as an investment adviser. Its principal place of business is 767 Fifth Avenue, New York, New York 10022. Since on or about July, 1972 Dreyfus has been the investment adviser and manager of the portfolio of the Dreyfus Special Income Fund, Inc.

Paragraph R, subparagraph 2 of Section II shall be amended and shall read as follows:

2. From on or about March 12, 1973, to and including March 27, 1973, while respondents III, Bristol Co., Dreyfus, Manning & Napier and TZP ("selling respondents") were in possession of material, nonpublic information conveyed to them by respondent Dirks, which information is set forth in paragraph 1 above, such selling respondents sold or caused to be sold Equity Funding securities from the accounts of others without disclosing such information to the purchasers of the Equity Funding securities sold or caused to be sold by the selling respondents.

Paragraph R, subparagraph 6 of Section II shall be amended and shall read as follows:

> 6. From on or about March 23, to and including March 26, 1973, Dirks conveyed the information set forth in paragraph 1 above to Dreyfus, which, on March 26, 1973, directed the sale for the Dreyfus Special Income Fund, Inc. of $500,000 face value of the debentures for net proceeds of approximately $362,993.

II.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III of the Order for Public Proceedings dated August 24, 1976, as amended, be held at a time and place to be set, and before an Administrative Law Judge to be designated by further order of the Commission, as provided by Rule 6 of the Commission's Rules of Practice.

IT IS FURTHER ORDERED that the respondent, The Dreyfus Corporation, file an answer to the allegations contained in the aforementioned Order for Public Proceedings as amended within 15 days after service upon it of said order, as provided by Rule 7 of the Commission's Rules of Practice.

If said party fails to file the directed answer, or fails to appear at a hearing after being duly notified, such party shall be deemed in default and the proceedings may be determine against such party upon consideration of this order fo proceedings, the allegations of which may be deemed to be true.

This amending order shall be served upon the respondents personally or by certified mail forthwith. The Order for Public Proceedings dated August 24, 1976, and this amending Order shall be served upon The Dreyfus Corporation personally or by certified mail.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision upon this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 4(c) of the Administrative Procedure Act, it is not deemed subject to the provisions of that Section, delaying the effective date of any final Commission action.

By the Commission.

/s/ GEORGE A. FITZSIMMONS
George A. Fitzsimmons
Secretary

EXCERPTS OF TESTIMONY OF RONALD SECRIST

[R. 242] Q Was there any discussion in the course of [R. 243] your conversation concerning how you had come to Mr. Dirks with this story?

Q Did he ask me that?

Q Or did you volunteer it?

A No, not that I recall other than I told him that we had a mutual friend in Pat Hopper. I may have implied that Pat suggested him.

Q Did he ask you whether you had any personal motivation in bringing this story to him?

A He most certainly did.

Q What did he ask you and what did you say to him at the time?

A Well, at the end of my story he leaned back—he'd been writing furiously. He had written out many pages in a three-hole notebook, 8½x11 size. I would—I don't know if it means anything—I would estimate he wrote eight or ten or twelve pages.

Mostly that's what he was doing, in answer to a previous question, he didn't ask very many questions; he just sat there writing all of the time.

At the end of our convesation or nearing the end of our conversation, he leaned back and looked me very squarely in the eye and said, "Why are you telling me all of this?"

Q And what did you say?

[R.244] A Do you want me to continue on with my answer?

Q Yes, please.

A And I said, "Because I want you to take this information and do something with it. I expect you, first of all, to verify it, not just take my word for it."

I gave him names of people he could verify it with.

I told him that I expected him to verify it and get the information out to stockholders or to the investing public. I

told him that I wanted to make it known generally, and that I felt that, if this information were widely enough circulated, that it would bring the result that I wanted.

He next asked me what did I want from all of this. I think more specifically: "What do you want from me?"

I repeated that I wanted him to give out the information.

And he asked me if I was expecting some payment from him.

I said, "Most certainly not." I told him that I had received an offer, a very circuitous offer, from someone who wanted me to make this information available so they could short the stock and then cause the stock to drop by revealing the information, and that I had refused [R.245] to talk to them.

Then he asked me if I had any interest in the stock.

I told him no. I very specifically said that I did not own any shares, that I was not short any shares, that I had never owned any shares, I had never exercised any of my openings, and on and on.

* * *

[R.331] Q Mr. Secrist, when you finally decided to share your information with the New York State Insurance Commissioner and with Ray Dirks, could you tell us, did you have a strategy in mind?

A Well, I put together an outline of what I was going to talk about, as I mentioned earlier.

[R.332] Q Did you ask Mr. Dirks to do anything with the information that you gave him?

A Yes.

Q What did you ask him to do with that information?

A I asked him to disseminate—well, I asked him, first of all, to check it out and verify its accuracy and authenticity and then to disseminate it as wisely and as quickly as possible.

Q Why was it important that the information be disseminated quickly, in your mind?

A Well, this comes back to my opinion of the SEC.

Q Go ahead.

A I felt that—

(Laughter)

A I felt that the regulators—well, I was of the opinion that the regulators had not acted in the past; which was off, on information that they had received.

I knew that other people had gone, at various times—and I had no idea how many more people may have gone, but this was talked of widely in the company.

I knew that every time somebody went to [R.333] a regulator with information and was brushed aside with a comment that that's a ridiculous story, that made it tougher for the next person to do.

And it was just a disgruntled employee or crazy employee action—in quotes—from the regulators.

I was of the opinion that it was necessary to put on as much heat as possible and as fast as possible.

I felt that the only way to resolve the problem was to bring the anger of the public opinion to bear in great force and effect on the regulators.

That would finally force them to move.

Q How was Mr. Dirks going to figure in this?

A Mr. Dirks was going to go to the heart of the matter, which was the stock price, which was the all-pervading interest in the corporation.

And by jarring the stock, he would jar the corporate—this was my plan—he would jar the corporate officers and would also rattle the Wall Street financial community to the extent that someone would take action very quickly.

* * *

[R.347] Q With respect to the same area that we have been going into as to your testimony yesterday, I believe you mentioned that you had some conversations with Mr. Blundell.

Do you recall that?

A Yes.

Q You did have some conversations with Mr. Blundell?
[R.348] A Yes, I did.

Q Do you know who Mr. Blundell is?
A Yes.

Q Who is he?
A He was bureau chief of the Wall Street Journal, Los Angeles.

Q And did Mr. Blundell call you or come to see you?
A He called me.

Q And where were you then, at the time?
A I was in Atlanta, Georgia.

Q And do you recall the gist of your conversation with Mr. Blundell?
A It was a very long conversation.
He called me at my—I believe the first time he called me that I was at my motel room in the evening.
It was rather late at night actually in Atlanta, like maybe ten—well, not real late, may ten o'clock or so.
As I recall, we talked for at least an hour, perhaps two hours.
The gist of the conversation, I guess I could fairly say I told him everything that I had told Ray Dirks.
[R.349] He was trying to put together a story.
I gave him as much information as I possibly could.

Q Did he tell you—
A I tried to back him up.
I tried to give him all of the detail, the authenticating information, the verification.
I was trying to help him write his story.

Q Did he tell you that he was going to write a story or that he was trying to write a story?
A I don't recall him specifically saying that, but I knew at the time that that was what he was doing.
I'm quite sure that he did tell me that in some form or other.

Q Do you recall the date of your conversation with Mr. Blundell?

A I don't recall it.

It's on the record.

I read it from my notes yesterday.

Q All right.

And—

A It was approximately two weeks after I went to the New York Department, within a few days.

Q Did you encourage Mr. Blundell to write [R.350] a story?

A Definitely.

Q Did you think that having an article in the—on your information in the Wall Street Journal was consistent with your plan?

A Most definitely.

Q Do you recall in the course of your conversation—I believe you testified yesterday that Mr. Blundell asked you whether you had any hard evidence in support of your allegations?

A Yes, he asked me that.

Q And what did you tell him about hard evidence then?

A I believe I told him what I had in my pocket at the time I talked to the New York State Department and Ray, which was those two little pieces of paper which have been entered into evidence here, or more.

And that we spent some time, perhaps a half hour, discussing this question at this point and in other conversations with him.

And basically, I told him that it just didn't exist.

I told him that in, oh, a dozen different ways.

[R.351] The only way he could obtain the information would be to get into the company and steal it and that it would be very difficult to do that.

Q You had, I take it, an understanding at the time of what Mr. Blundell was using the term "hard evidence" to mean?

A Well, he made it very specific.

There was no question about what he was asking about.

Q And what was he asking?

A He wanted proof, he wanted documentation, he wanted pieces of paper that would prove the story so that he wouldn't be involved in possible libel.

Q And the only documentation that you had were the two confirm slips which have been introduced this morning as Exhibits 3 and 4 for the division?

A Yes.

I would say that was the only documentation that I had which would be of any significance to what he was trying to accomplish.

You know, I had things like convention statements, annual statements and normal company financial material things.

* * *

[R.359] Q Why did you go to see Mr. Dirks?

A We had mutual acquaintances.

I had known of Mr. Dirks for a period of over two years.

I had never met him or talked with him, though.

I had read an article about him in the Wall Street Journal.

Our mutual acquaintances were of the opinion that Dirks was a very ethitical [*sic*] man who would use this informatioon in what I considered the proper manner.

[R.360] Basically, I thought that he was the man who could do the job.

Q And—

A He was well known as a life insurance analyst, which I should put in also—an insurance analyst—which is significant, of course, so he could understand what I was talking about.

Q And by using it in the proper manner, you meant disseminating it widely?

A Yes.

Q Did you tell Mr. Dirks when you met with him that you'd been fired by the Equity Funding Group?

A No, I did not.

Q What did you tell him?

A I told him that—I believe that I told him that I had resigned.

He asked me that question.

I tried to sidestep it.

Finally he pinned me down, and I had to come up with some sort of a statement.

I felt that I wasn't lying on that point because the officer can't be fired except by the Board of Directors, because that's who appoints him.

So, technically, an officer has to resign.

Q Well, why didn't you tell him—

[R. 36l] A I was asked, but I still—

Q Excuse me.

Why didn't you tell him pointblank that you had been fired?

A I felt that would cloud the issue.

I felt it was immaterial to what I was trying to accomplish.

I was going to do this regardless of whether I was fired or quit or whatever.

Q You mean when you say, "cloud the issue," you mean affect your credibility?

A I was afraid it would make me look like a disgruntled employee trying to get even with somebody, which was not the case.

Q And for that reason, you told Mr. Dirks when you couldn't sidestep it, you told him that you had resigned?

A Yes.

Q Were you concerned about your credibility when you went to see Mr. Dirks?

A Most definitely.

Q Why were you concerned about your credibility?

A As I have said before, I felt that I had one bullet to shoot.

If I missed, it was all over.

I felt that I had to make the most credible [R. 362] statement possible, that I had to present myself as a reliable, responsible member of the business community and that I had to convince him thoroughly that what I was saying was correct and true and convince him enough that he would act on the information.

Q And didn't you think that the story you were telling was kind of believable on its face?

A No, I did not.

Q I see.

A No rational man in the life insurance industry would say this is possible to do.

Q So you thought you were laboring from that position of disadvantage to start with, you didn't want to add to it by telling him that you had been fired?

A I was at a gross disadvantage.

* * *

[R. 369] Q When you talked to Mr. Dirks over lunch on the 7th of March, did you talk about the Wall Street Journal at all?

A Yes.

Q And how did that arise?

A Well, a couple of things.

I mentioned the article about him for one thing, [R. 370] you know, as part of the reason that I had come to him.

And another thing, he mentioned Herb Lawson, Bureau Chief of the San Francisco Bureau, and asked my permission to give this information to Herb Lawson.

Q Which information?
A The information that I was giving Ray.

Q So Dirks told you that he was going to take this information to the Wall Street Journal?
A He asked my permission to do so.

Q Did you give it?
A Yes.
I believe he may have made a statement further than that.
I don't recall precisely at this time.

Q Did you have occasion in that meeting in in [*sic*] any of your conversations with Mr. Dirks, to tell him that you knew that people had taken the information that you had or similar information to the Securities and Exchange Commission?

* * *

[R. 371] A Yes.

Q When did you tell Mr. Dirks that?
A Well, we discussed it in nearly every one of our phone conversations after the original meeting.
At the original meeting, I don't recall whether we discussed it or not.

Q And when you say you discussed it, do you recall what was said about persons who had previously gone to the SEC?
A Well, we discussed the fact that they got no results and that they were placed in personal jeopardy as a result of having gone there.

[R. 372] Q And when you say placed in personal jeopardy, what do you mean by that?
A There [*sic*] lives were threatened in the corporation; their positions, their careers and their jobs were threatened or they were fired or whatever.

* * *

[R. 453] Q Now, I believe it was on March 7, 1973 that you talked first to the New York State Insurance officials and then later that day to Mr. Dirks.

Is that correct?

Is that the date?

A Yes.

Q How much time did you spend with the New York State Insurance officials?

A Approximately three hours.

Q Did the ground covered in your conversations with the New York State Insurance officials differ or was it the same as that—or substantially the same as that covered in your later subsequent [*sic*] conversation with Mr. Dirks?

A It was virtually the same.

Q Did you tell the New York State officials [R. 454] that you were going to see Mr. Dirks?

A I did not.

Q Did you tell them that you had—

A I did not at the time I talked to him the first time, on March 7.

Q Yes.

That's when I'm referring to.

Had you by then had your conversation with the Wall Street Journal reporter who was in Los Angeles?

A No, I had not.

Q That occurred subsequently?

A Yes.

Q I see.

On March 7, 1973, Mr. Secrist, was it your then intention [*sic*] to talk only to the New York State officials and to Mr. Dirks?

Or did you have in mind possibly talking to other people too?

You have testified at another point that you considered the possibility of talking to various other people, including certain

U.S. senators and Jack Anderson, who is a columnist, and other people.

Did those possibilities exist in your mind at the time that you talked to the New York State Insurance officials?

[R. 455] A No.

I was set on talking to those two entities, and that was all.

Q As of March 7, 1973?

A Right.

Q But this list you drew up, had you drawn that list of possible persons to talk to prior to March 7?

A Many months prior.

It was a dynamic list.

I was adding and subtracting over a period of many months.

Q Yes.

But by March 7 had you—you had more or less settled on talking to these two particular—

A I had firmly settled on those two, yes, your Honor.

Q Just to recapitulate:

You didn't tell the New York State Insurance officials that you were going to talk to Dirks?

THE WITNESS: That's correct.

Q And you didn't tell Dirks that you had earlier talked to the New York State Insurance officials?

A Not on March 7th, no.

[R. 456] Q And again, your reason for that was what?

A The reason I did not tell Dirks is because the New York State Insurance officials told me not to tell anyone that I had been there or not to discuss it in general.

The reason I didn't tell the New York State Insurance Department because [*sic*] I suspected they might not be too happy about me talking to someone else.

I had already made up my mind that I was going to do it.

They asked me if I had talked to someone else, which I could answer honestly, no.

They didn't ask me if I was about to.

Q Why did you feel it necessary to explore both of these avenues or try to utilize both of these avenues for making sure that the disclosure was made?

A Because I didn't have total confidence in any regulatory body that they could achieve the goal that was necessary in revealing what was going on at the company.

I felt that I had to have additional leverage and just like presenting a court case, I wanted to present my best case the first time.

* * *

[R. 458] Q And what did you expect Mr. Dirks to do with this information?

How did you contemplate that his knowing this information would result in its becoming broadly known to the investment community or to the public at [R. 459] large?

A Well, I understood him to be very active in analyzing insurance securities.

Therefore, he would be—therefore, he and his firm, your Honor, would be well known to investers [*sic*] in insurance securities.

I expected him to disseminate this information to his firm's customers, clients.

Q You didn't expect him to be—to put a notice in the Wall Street Journal, did you?

A Hardly.

Q Or write an article in one of the business publications?

A No.

I perhaps naively thought that—I didn't know what technique he might use, but I thought perhaps he might send it out in some kind of a bulletin to his clients.

I didn't really—I had not thougth [*sic*] through that thing.

I figured that that was his province, not mine.

Q Did you discuss with him at all what follow-up he would make or what he would do with the information that you were conveying to him—

[R. 460] A Yes.

Q other [*sic*] than the first checking—other than first checking it out?

A Yes.

As you say, I told him that I expected him to check it out.

I felt that added to my credibility.

I certainly would not expect a man of his calibre to go out and take a comment from one individual and start spreading stories as wild as the one that I was telling him, or apparently wild.

And, yes, we discussed at some length, your Honor, perhaps for 20 minutes or so, what I had expected him to do with the information.

Q What was that conversation?

What did you say to him and what did he say to you?

A Well, when I concluded my speech, if you will, my formal presentation, I stopped talking and waited for him to ask me a question, or whatever he was going to do.

And when he finished writing what he was writing, his notes, he leaned back and said, why are you telling me this.

And I sayd [*sic*], I want you to check this [R. 461] information out and satisfy yourself as to its authenticity and then disseminate it to the investment community.

And we discussed that at some length as to how he's [*sic*] going to disseminate it and how he would check it out and things of that nature.

Q With respect to checking out, did you discuss at all if he found the information to be verified by other sources—did you discuss what he would do with it, what the mechanics would be?

A No, no.

We didn't discuss mechanics.

I just told him that I wanted him to get the information out as broadly as possible.

My goal was not publishing a newspaper.

My goal was getting the situation that was going on at the company stopped.

This was a means to an end.

This was not an end, the publishing of the information.

Q I think you testified earlier at one juncture that your purpose was to jar the Equity Funding stock.

And by that I take it to mean you meant that you hoped that through Mr. Dirks, the stock of Equity Funding would drop precipiously [*sic*].

I think you said to zero.

[R. 462] A I said that in my testimony, yes.

I expected it to drop close to zero very quickly, yes.

Q And that was your purpose in talking to Mr. Dirks?

A That was not my purpose, that was one of the steps in achieving my purpose.

Q And what was your long-range, overall purpose?

A My purpose, your Honor, was to reveal the fraud to the world.

Q All right.

A And to prevent its continuation.

* * *

Q Mr. Secrist, I believe you just stated, in response to one of Judge Markun's questions that you did not contemplate that Mr. Dirks would get this all published in the Wall Street Journal.

[R. 463] Is that what you said?

A I think the way he said it was—I interpreted or I understood the way he said it is that his firm would take an ad in the paper or something like that.

That wouldn't seem reasonable to me.

Q I do just want to make it perfectly clear that your testimony was that you and Mr. Dirks did discuss in that meeting the possibility of his going to the Wall Street Journal with the story.

A We discussed going to the Journal and having a reporter do the work, but not Mr. Dirks himself putting the story in the journal [*sic*].

Q All right.

But you were perfectly aware, then, weren't you, that Mr. Dirks might well take this story to the Wall Street Journal and use that to disseminate it?

A I expected that he would.

Q Thank you.

* * *

EXCERPTS OF TESTIMONY OF RAYMOND DIRKS

[R. 476] Q Did there come a time in March of 1973 when you were contacted by Ronald Secrist?

A Yes.

Q All right.

Do you remember when that was?

A March 6, 1973.

Q And do you remember the nature of the contact?

A A telephone call.

* * *

[R. 477] Q What did Mr. Secrist tell you?

A Well, to the best of my recollection he said he thought—he introduced himself and said he was a friend of Patrick Hopper and that he had once worked for Equity Funding Corporation and Bankers National Life and that he had some information he thought I would be interested in hearing about.

He sort of rambled on about Y business, about one-third of thdir [*sic*] business he alleged was fictitious life insurance business.

I believe he was referring to Equity Funding Life Insurance Company.

I think he said something about fake certificates of deposit and other sorts of activities that would indicate the company was doing some mighty unusual things.

And he said he wanted to—I don't remember all of the details from memory.

He said he wondered whether I would be interested in hearing.

Well, I don't think he—I think I said, well, if you have something, why don't you come in and see me.

He said that he would like to come in.

I said that if you want to come in—when [R. 478] would you like to come in.

He said, tomorrow.

I said, about what time.

He said, around midday.

I said, I have a one o'clock appointment.

He said, it would make it kind of difficult for me to try to get up a little before one or before, I think twelve.

I said, would you like to have lunch.

He said he didn't know whether he would have time to have lunch but that he would try to be there before I had to go to my one o'clock appointment.

Q And in fact did Mr. Secrist keep his appointment with you for the day following?

A Yes.

Q Can you tell us what took place?

A Well, as I recall it, I was—he didn't get there until about 12:30.

I told Allen Gorrelick, who was the life insurance specialist, more or less, that since this individual had called, that it sounded like a very strange and crazy story—I described it briefly to Allen—and I said maybe you will have to go along on this.

He said he didn't think it was of any interest.

[R. 479] Well, I said I might have to go to lunch, so when he comes in—or, I might have to go to an appointment—that when he comes in, would you take care of it if I'm not here.

He said he would.

But about 12:30, Secrist was announced.

I went out to greet him.

I brought him into my office.

I said to Allen, come on, let's go to lunch. Secrist said he would go out to lunch.

So we went out to P.J. Moriarty's.

Q And how long did you stay with Mr. Secrist?

A I think about three and a half hours.

Q Can you tell us what he told you?

A Well, in essence, he started off by saying that he was at Bankers Lifre Insurance [*sic*] Company where he had been for over a year.

He said that he was—but that he had left there—I'm sorry, when I say was, he had been there, he left there. He was no longer employed, that he had resigned.

He said there were a lot of—that a number of other officers of Bankers National were dissatisfied and some of them were leaving or had left recently, including the actuary and the chief accountant.

[R. 480] He said that at Bankers National, the company was—the reasons a lot of these people were leaving was that they were dissatisfied with the way the management of Equity Funding was allocating expenses.

They were not happy with the way the company was being managed.

He indicated that it was a very sloppy organization.

He indicated also that he had been led to believe a few months earlier that he was going to be made the chief operating officer at Equity Funding, that this had not come to pass—I mean, of Bankers National—I'm sorry—and that this had not come to pass.

He went into great detail about that company.

He also indicated that he had some allegations to make about Equity Funding, namely, that he claimed that someting [*sic*] in the area of one-third of their life insurance in force was fake and that they called this the Y business.

This resulted, he thought, in fictitious assets.

He wasn't sure how this occurred exactly.

He indicated that he had worked at Equity [R. 481] Funding up until about a year and a half ago, prior to that, rather, and that he was—and that there had been a lot of common talk around the company about this fictitious insurance in force.

He said that people had told him that the company was not only creating fictitious insurance in force, but they were making up fake—but that they were selling this insurance to other insurers through the device known as co-insurance.

He said that the company was—that officials of the company or someone at the company was making up fictitious death certificates to collect the proceeds of these fictitious insurance policies from other life insurance companies.

He thought that—he said that from what he heard there was fictitious certificates of deposits made up to create fictitious assets.

He said that the company used some sort of outside printers to accomplish this.

He alleged that most of the top officers of Equity Funding were probably involved in this alleged creation of fictitious insurance.

He named quite a few individuals that he thought were involved.

He named some others that he thought were not [R. 482] involved.

He said he didn't know much, if anything, about the parent company, Equity Funding Corporation of America.

He said there was no real fraud at Bankers National, that that had been given some—or, asked to reinsure some fictitious insurance that—well, actually he wasn't sure whether it was fictitious, but the Pennsylvania Life had been given some of this—he thought had been given some of this Y business and that Pennsylvania Life had told Equity Funding that they didn't—that they didn't like that business and they wanted Equity Funding to take it back.

So Equity Funding was attempting to force Bankers National to accept this fictitious business.

Obviously it was a three and a half hour conversation, so he went through a lot of additional material which I'd be happy to try to recall.

I don't know what you are—what you want me to do here.

Q Well, did you take notes at that meeting?
A Yes.

Q Do you have a copy of those notes with you?
A Yes, I do.

[R. 483] Q Perhaps—have you exhausted your recollection of what took place there?

A I don't think so.

Q Why don't you keep going and then when you get to the end of your present recollection, then refer to your notes, fill in the gaps.

A Well, naturally he told me about his history in the insurance and how he had come to arrive at Equity Funding.

We discussed Pat Hopper and we both had some acquaintance with him, although I had only met once in my life and only had talked to him two or three times.

We talked something I think about Pacific Standard Life.

We discussed what he—what his administrative role was at Equity Funding.

I don't believe he said he was an officer of Equity Funding Life, but he did say he was an officer of Bankers National.

We discussed his perception of some of thes [*sic*] individuals that he had said were responsible primarily for this allegedly fictitious insurance.

He indicated that Fred Lavin [*sic*] was sort of the mastermind of the whole affair as far as he knew.

He said that he didn't know, to his knowledge, [R. 484] about some of the others.

He indicated Art Lewis was sort of the evil genious [*sic*], I think he called him.

He mentioned Eden and—let's see—I think Sultan and Collins and Simons and Banks and all these people who were not listed in the annual report of the company as I later discovered.

They were, he claimed, knowledgeable about this particular fictitious insurance.

Let's see.

He indicated—well, naturally, of course, I asked him what the purpose of this whole—well, I think I asked him why he was—why he thought these guys were doing what they were doing.

He said they were—he said none of them were—none of them had managerial experience, they were all technicians.

He listed their, more or less, professional backgrounds.

He indicated they were mostly accountants or actuaries or lawyers but they had no—they were very bright people, high IQ's, 140 or 150 or more, but that they had very little in the way of administrative experience.

Therefore, the whole place out at Equity [R. 485] Funding Life, as far as he knew it, was in pretty much dissaray [*sic*].

He said that it was common knowledge, all this, what he was telling me, had indicated that it was common knowledge around the water cooler where everybody talked about it.

He said it was treated as sort of a joke. People in charge, these individuals he had named, he said they were bery [*sic*] young executives, way over their heads, even though they were smart.

Then he said they really didn't realize, he didn't think, what they were doing.

He didn't even know whether they realized that it constituted a fraud.

Of course, I asked him whether he had any sort of documents or whether he had any materials that he had brought him to substantiate some of this that he was telling me.

He said he really did not.

He sort of sheepishly pulled out a couple of pieces of paper and said, well, this is about the only thing that I got.

He showed me two confirm slips which he said represented funded programs accounts that had been sent to him.

[R. 486] Q I show you Exhibits 3 and 4.

Are those copies of what Mr. Secrist showed you?

Of course they would have been folded at the time.

A Yes.

They don't look exactly the same.

I thought it was just one piece of paper.

It could very well be that he showed me this.

MR. MEISTER: I object and move to strike as to what could be.

I ask the witness to state whether he remembers or doesn't remember.

JUDGE MARKUN: I will ask you to give your best recollection as to whether you have seen these documents before.

THE WITNESS: Well, your Honor, I definitely remember seeing the names Christ and Secret.

I presume this is it.

My best recollection would be that it would be these documents.

JUDGE MARKUN: All right.

THE WITNESS: But I don't believe—for one thing, your Honor, he didn't give them to me to keep.

[R. 487] They didn't seem to have very much significance.

In any event, he said that he really didn't have any other evidence.

He didn't indicate that he himself—

Q Any documentary evidence, Mr. Dirks?

A Well, right, that's correct.

Q Do you remember anything else that was said?

A Well, naturally I asked him if he, himself, had been engaging in any of these activities or was directly knowledgeable about it.

He indicated to me that he had not and really had no direct knowledge of the accounting, how the books were affected.

In fact, he—it was pretty much speculation as to how this whole thing showed upon the asset side of the balance sheet or on the income statement.

* * *

[R. 488] He indicated that—well, of course, we asked about—when I say we, I'm talking about both Allen Gorrelick and myself.

Allen Gorrelick was present at the meeting, as I indicated earlier.

We pressed him on how this could have—on how this sort of alleged fraud could have occurred in the face of the substantial amount of regulation that the company had in terms of both from the insurance departments of the various states and from the SEC and, of course, the auditing firms.

I asked him who the auditors were.

I don't think he was completely sure of who the auditors were at Equity Funding Life, at the present time at least. That was 1973.

The auditors—he said he was more aware about, I think—most aware about, as I recall, were the [R. 489] ones for Ranger National.

He mentioned Peat, Marwick, Mitchell coming in and how they seemed to have come very close several times to discovering this alleged fake insurance, but how the various officials at the company had intimidated the auditors by throwing them out of the office or—particularly some of the young auditors that came in.

He indicated that he thought the company had—that the company officials had occasionally made up fake insurance policies in order to show the auditors but that this wasn't necessary for every policy, that it would be impossible to do that, or the number of policies that he was claiming fraudulent.

Of course indicated that other people—you know, it was generally common knowledge within the company about the fraud, about the alleged fraud, and that some of the people in the company were caught up in it, they saw it as a way to get status in the community.

He said many of these officials that were involved didn't really make a lot of extra money by getting involved but they were—but they wanted status, they wanted to get promotions, they wanted to become well liked and known among their peers and so forth.

[R. 490] He said others within the company were not at all happy with what was going on.

He said that some people—quite a few, had left the company.

He indicated that some of them had tried to go to the regulatory authorities without success.

He said he thought it would be very difficult to have this thing exposed or brought to the—to a halt by going to regulatory authorities.

He talked about the insurance departments, the SEC, the accounting firms.

Of course he said he didn't trust the Illinois Insurance Department.

He indicated Fred Levin had worked there as an attorney.

He said he was told that the Illinois Insurance examiners had been paid off, by Equity Funding.

Naturally I asked him why he came to me.

He said he came to me because Pat Hopper had recommended me.

He thought perhaps I could check out some of these—some of what he said and see if I could do something about it.

He indicated—I think we spent quite a [R. 491] bit of time on the sales force.

He indicated he felt an analyst by looking at the annual reports and looking back over the history of the company and knowing what the number of salesmen were, which was generally public information, and looking at the amount of sales the company reported, could become somewhat suspicious about whether or not the company was reporting true sales figures.

I think we discussed the other insurance departments at some—whether they had any knowledge of this.

I think he indicated that other approaches had been made to the various insurance departments.

He indicated some people had gone to the SEC without success.

I told him that I thought that if he expected me to do anything about this, that I wouldn't feel comfortable unless I could talk to somebody that I felt would have the type of experience and ability to expose this fraud.

I mentioned the Wall Street Journal.

I specifically mentioned that I knew a fellow named Herb Lawson who was an investigative reporter with the Wall Street Journal.

I told him tht Herb Lawson had good [R. 492] contacts with regulators, and that, through somebody like Herb Lawson, that I thought that, if I could get him interested in this, that we

might have some success if this fraud existed after I checked it out, that we might have some success in getting done what Secrist seemed to want done.

I specifically asked his permission if I could contact Herb Lawson.

He said—He thought for a minute. Then he said, "Yes, if you think so, if you think that's best," or something to that effect.

* * *

[R.493] He made it clear that he didn't want his name bruited about. That's of course why he had done that before I brought up Herb Lawson, and that's why I specifically got his permission to talk to Herb Lawson.

I assured him that I thought a reporter with a respected publication like The Wall Street Journal would not divulge his source.

* * *

[R. 614] Q And were you asked this question:

Did you do anything about the information that Mr. Secrist gave you between the 7th and the 19th?

And did you give this answer:

Yes. I did some analysis and research on the company. I took my file, which was fairly extensive, and analyzed the company.

I checked my records to see if any of my clients owned the stock and I found that only—well, first of all, I recalled immediately before I checked my records that one institutional analyst had come in to see me bout [*sic*] two months before about it and his name is Jerry Zukowski. He works for Boston Company Institutional Investers [*sic*].

Did you give that answer?

MR. DEITZ: And, gentlemen, if you want to add to it because I've not read the entire answer, just the first two paragraphs, I'll have no objection.

BY MR. DEITZ:

[R. 615] Q Did you give that answer?

A Well, that was the—that's what I said there.

Q And was it true?

A Well, it is obviously not completely clear.

The way I—I did not check my records to see whether any clients owned the stock.

I recalled, as I testified earlier, that one—that one individual expressed an interest to me in Equity Funding.

I did not know whether—who owned the stock.

I never did learn whether anybody that I talked to—had talked to owned the stock.

* * *

[R. 789] Q Well, weren't you impressed enough with what Mr. Hopper had told you that you asked him if he would talk with your friends at the Boston Company Institutional Invester, Inc. [*sic*] on the telephone?

* * *

A Well, I was impressed enough with Mr. Hopper as an individual that I thought that I was impressed with his credibility.

[R. 790] I thought that—I think what—after we had this meeting in the breakfast room, I went up and got some message.

I believe there was a call from Mr. Zukowski and I belive [*sic*] I picked up the phone and called him and I said, you know, by the way, Pat, would you mind talking to Mr. Zukowski.

And he said sure, why not.

I'll be happy to tell anybody that I—what they want—you know, whatever they want.

I'll be happy to talk to anybody.

It was something like that.

Q And did you in fact call Mr. Zukowski on the 20th?

A I believe I placed a call to Mr. Zukowski on the 20th from my room at the Beverly Wilshire.

Q Was the call connected?

Did you talk to Mr. Zukowski?

Q And did you put Mr. Hopper on the line?

A Yes.

Q Was the Equity Funding letter discussed in this conversation?

A Well, I only heard one side of it.

But my impression was that—well, I [R. 791] know that Mr. Hopper was talking about Equity Funding.

Q And how long did the conversation last?

A I don't remember.

It didn't seem to me like it was very long.

I thought maybe five or ten minutes.

* * *

[R. 797] Q Now, returning to your meeting with Mr. Majerus, about what time did that meeting begin on the 20th of March?

A Oh, I think it was around 1:30, somewhere in there.

* * *

[R. 798] Q How long did you meet with Mr. Majerus?

[R. 799] A I think it was about an hour and a half.

* * *

[R. 801] I asked him if he had been involved in this.

He said, well, he had had—that he had had—that he had made up—that he had helped Pat make up some pencil ledgers, or something, at the request of Lloyd Edens, I believe it was.

And at that point he sort of dropped his head down and said, "I think I'm going to jail."

* * *

[R. 803] Q Now, on Wednesday, the 21st of March, did you have a call from Zukowski at III?

A I don't remember whether he called me or—I remember I did talk to Mr. Zukowski on the morning—at least it was the morning in California, the 21st.

[R. 804] Q And do you remember what you spoke about with Mr. Zukowski?

A Some of it, yes.

Q Can you tell us what you remember of that conversation?

A Well, it may have been in that conversation that he indicated that he didn't think much of Mr. Hopper's comments in terms of these allegations by Secrist but he said that—and he said that he thought there was less than a ten percent chance there was truth in these allegations and that he thought they were making a mistake in terms of—meaning the institution that he worked for was going to sell their stock.

He thought they were probably getting out at the bottom.

He indicated to me that they were planning to send commissions to Delafield Childs in the amount of $25,000.

I think that's what I remember, basically.

* * *

[R. 1127] Q Now, on the 23rd did you speak to anyone at III?

A Yes.

Q Who was that?

A Jerry Zukowski.

Q Did you speak to Mr. Baker on that day?

A I don't recall.

I thought I spoke to him the day before. I am not sure.

Q What did you tell the people at III on the 23rd?

A Well, I said, Jerry, I know that you think you made a mistake when you sold the stock, but I have talked to a few more people and they are tending to substantiate the story that the—of the allegations [R. 1128] that these other individuals had given to me.

And I said something like, well, maybe you didn't get out at the bottom or something to that effect and maybe that will make you feel better or something.

We were sort of joking and he said, well, it makes me feel worse, because we just went through our office here and we found out that some of the stock we sold was bought by our affiliate, John W. Bristol & Company.

And I said, well, if you want to have Mr. Bristol call me, why, I'll be happy to talk with him.

* * *

[R. 1134] Q Now, on the 24th, which was Saturday, did you have any conversations with Mr. [Anthony] Orphanos [a securities analyst with Dreyfus Corp.]?

A Yes.

Q Could you tell us about those conversations, please? Did you have one conversation or more than one?

A I think I had more than one but I don't recall exactly.

Q What did you say to him and what did he say to you?

A Well, I told him I had gone to the accountants, I believe.

I told him that or I was going to the accountants but—and that I was hoping the stock wouldn't that—or I think I indicated I didn't think the stock was going to trade any more, at least until the accountants could find out what was going on at the company.

And I told him—

Q Did you expect the accountants to do something after you had spoken to them?

A Yes.

Q What was that?

A I thought they would contact the New York [R. 1135] Stock Exchange and the SEC and ask those institutions or regulators to hald [*sic*] the trading until they could check into this.

Q Why don't you continue with your conversation ith [*sic*] Mr. Orphanos?

A I said to Mr. Orphanos that I would—well, I was looking for all the help I could get.

And that I was—I thought I would give him the names of some of these people I talked to.

And I gave him the number of Ron Secrist and I believe some of the others.

I am not sure whom but in any event, I did give him several names and phone numbers, people to call.

I think I gave him Pat Hopper and some of the others as well.

I suggested he call himself.

Q Was there any discussion at that time concerning whether Dreyfus had Equity Funding in any of the accounts that it managed or funds that it managed?

A Well, I think there was—I think he indicated they had some stock, I believe.

That is my best recollection that they owned some stock.

* * *

[R. 1136] Q Now, on the 24th did you also meet with Mr. Balint?

A Yes.

Q What was said at that meeting?

A Well, he came by my hotel and I said, well, should we go to dinner down here and—down the street?

He said, no, we'd better get out of this area.

So we went up about 20 miles down the coast and then we proceeded to have dinner.

We talked at great length about accounting for life insurance companies, how long he had been the accountant for Equity Funding and what his—what his—the—

Q How long had that been?

A I think they became the accountants [R. 1137] shortly after the company came to California.

It was about 1967.

JUDGE MARKUN: Excuse me.

Did you say 1967?

THE WITNESS: Yes. 1967.

JUDGE MARKUN: Thank you.

A (continuing) And of course also we talked about how they would—they were not any longer the accountants.

I believe they left and the last time they did an audit was '71.

It might have been '70.

I am not sure.
I believe it was '71.

* * *

[R. 1138] Q Now, did Mr. Balint indicate that he had heard of the fraud at Equity Funding prior to your describing it to him?

A Well, he didn't indicate that he had heard of the fraud.

Q In fact what did he say?

A Well, he say [*sic*] he couldn't understand how this kind of thind [*sic*] could have occurred when he was a partner in charge of the audit and when he had spent a lot of time over at Equity Funding and when I gave him a list or recited a list of 45 people that allegedly knew about it, he was quite astonished, particularly when I brought up Frank Majerus, whom he said he had just talked to the week before.

He did say that if management—if the top management of the company is in collusion, perpetrated a fraud, why it was conceivable that this could have happened, and he wouldn't know about it.

This was about a seven-hour conversation, incidentally.

Q Did you have your notes with you at that time?

A No.

I told him I had my notes back at the hotel.

[R. 1139] Q Did you discuss the substance of those things that were on your notes?

A Yes.

Q And Mr. Balint indicated to you that he had heard none of these things prior to that dinner meeting with you?

A Well, none of the things that pertained to allegations of improprieties and things of that sort.

* * *

Q Mr. Dirks, in this meeting on the 24th, was that the result of your conversation with Mr. Balint on the 23rd when he asked you to call him back at his house and after—one hour after he advised you to change hotels?

A Yes.

Q Now, on the 24th, did you also have a meeting with Mr. Spencer of Seidman and Seidman?

A Yes.

Q And did Spencer tell you that he would hold up certification of the audit and look into your allegations?

[R. 1140] A Well, in answer to my question as to what he would do about the certification of the audit, he said he would certainly look into this before releasing any certification or he said something like we'll have to look into it.

Q Now, on the 25th, did you have occasion to meet with Mr. Quinn?

A Yes.

Q Where did that meeting take place?

A At his hotel room, I believe at the Beveraly [*sic*] Wilshire Hotel.

Q And who arranged the meeting?

A Well, Mr. Orphanos, I believe arranged the meeting.

Q How long did it last?

A Not very long.

Just a few minutes.

At least in terms of any discussion about Equity Funding.

Q What did you say and what did he say?

A Well, he just said what's the story and I think I—I think I told him that that—you know, previously about the allegations and then I told him that I had had a—set up a meeting for Mr. Majerus, Mr. Hopper to meet with Mr. Blundell and after that meeting I'd arrange—I had reached Frank Majerus and asked him to call Mr. Balint and tell him [R. 1141] what he had told me in essence and that I then called Mr. Balint and he acknowledged Mr. Majerus had called him and so I told Mr.—in essence I said, you know, I did put the former controller of the life insurance company in touch with the former partner in charge of the audit there.

Q And did you identify these persons by name?

A I think I did.

I—I don't think it was—I don't think he was that interested in taking down names.

Q What was the import of this?

What was the importance of that?

MR. GREENWALD: The import of what, Your Honor?

MR. DIETZ: Of Mr. Dirks' statement that he put the former controller in touch with the auditors.

BY MR. DEITZ:

Q Did you discuss anything on that point?

A Well, I told him that I thought it was pretty significant that I had gotten the former controller of the life insurance company to call up the partner who had been in charge of the audit whom he knew personally and apparently they had a high regard for each other, and to have the former controller allege that there was—that there had been—well, of course, I didn't know actually what he said to the former controller, but I was assuming [R. 1142] what he said would have some—tend to put further doubts in the auditor's mind and perhaps get him to do something.

* * *

[R. 1150] Q And did you call Fidelity Management and Research in Boston?

A Yes.

* * *

[R. 1151] Q And what is your present recollection of that conversation?

Did you ask them whether they owned the stock?

A Well, I asked him if he had an interest in Equity Funding.

Q And what did he say?

A No, he did not.

He said he did not have an interest.

Q Did you ask whether they had an interest or whether they owned stock?

A Well, I always ask whether they have an interest—if they're not interested I don't ask people do you own the stock.

A [*sic*] Well, why don't you read on page 470, starting with the question at line 19?

A Question: How about Fidelity?

Answer: The same thing.

Well, Fidelity, they didn't own the stock so I really didn't give them the story.

* * *

[R. 1248] Q Going back to March 12th, Mr. Dirks, I would like to ask you some questions about that date.

Do you know a Mr. Herb Lawson?

A Yes.

Q You knew him on March 12, 1973, did you?

A Yes.

Q I believe you testified he was an employee of the Wall Street Journal?

A That's correct.

[R. 1249] Q Did you place a call to Mr. Lawson on March 12th?

A Yes, I did.

Q Where was Mr. Lawson located at that time?

A Well, his office was at the Wall Street Journal in San Francisco, where he was bureau chief.

Q Why did you decide to call Mr. Lawson on or about the 12th of March?

A Well, I thought that I would try to have somebody who could generate publicity about this investigation it—investigate with me or separately and I wanted to give him the allegations by Mr. Secrist in order that he could do something.

Q All right.

Did you reach Mr. Lawson on the 12th?

A No.

No, I—as I recall he wasn't there and I think—I may have left a message but I don't recall specifically.

Q Do you recall whether he called you back?

A No, he didn't call me back.

* * *

[R. 1259] Q All right, sir.

Now, on March 19th, which is a Monday, 1973, did you have occasion to speak to Mr. Lawson at the Wall Street Journal?

A Yes, I did.

I talked to him on the telephone.

Q Did you call him or did he call you?

A I had placed a call to him.

Q And—

A I believe I connected with him right away.

Q Do you recall how long that conversation lasted?

A I think it lasted for perhaps 15, 20 minutes.

Q And do you recall what time of day it was?

A Well, it was in the afternoon in New York, and I think in the morning in San Francisco.

Q Do you remember what you told Mr. Lawson?

A I told him that a former employee of Equity Funding had come to me and recited a long list of allegations about the creation of fictitious insurance at Equity Funding and that this involved creation of fictitious assets, fake death certificates, printing up fake certificates of deposit and other securities and that this former employee [R. 1260] had indicated that—that the fraud was being carried out by senior officials at Equity Funding Corporation in Los Angeles.

In summary, I recited the allegations that Mr. Secrist had given to me and suggested to Mr. Lawson that perhaps he would like to look into these allegations and see if he could get to the heart of them, and that I would like to cooperate with him in the investigation.

Q In the course of your conversation, did you happen to tell him about the conversation you had with Stanley Goldblum on the 12th of March?

A I think I mentioned that I had spoken—that the company had recently reported earnings and that Mr. Goldblum and I had had a conversation in which Mr. Goldblum said everything was going along fine and in substance denied the allegations.

Q All right.

Now, what did Mr.—what was Mr. Lawson's reaction to the story you told him?

A Well, he said that he—that he was pretty busy right then.

He was—he had to go to a Bank of America annual meeting the next day or two, and had to prepare for that.

He also said that he didn't know whether the—[R. 1261] he could look ito this himself because Equity Funding was located in Los Angeles and he would have to—possibly have to refer it down to Los Angeles to see whether they would be interested in looking into it.

Q All right.

Did Mr. Lawson indicate to you that he thought that he would be ready or that the Journal would be ready to print the story based upon what you told him?

A No, he did not.

* * *

[R. 1263] Q * * * Why did you relay the information or allegations that you had from Mr. Secrist and Mr, Goldblum to Mr. Lawson at the Journal?

A Well, I thought that if—in fairness to Mr. Secrist, if there was any truth in what he said, it was my responsibility to try to do what I could to help expose this alleged fraud and it seemed to me the best way to do it would be to go to a highly respected financial publication, to a journalist whom I personally knew, who I thought would—if he took this—these

allegations seriously he would investigate it and determine the truth of it and make it public.

* * *

[R. 1264] Q Did Mr. Lawson's reaction to your telling him the information had you had, make it seem to you that it was likely that the story was true?

* * *

A I think—the answer is no.

If anything was less believable—I might say when I first talked—started the conversation I said this [R. 1265] sounds like an unbelievable story, Herb, but—he didn't do anything to—to change that view of mine.

Q All right.

Now on March 19th, did you have occasion to speak to Mr. Ronald Secrist again?

A Yes, I did.

Q Did you call Secrist or did he call you?

A I called Secrist.

Q And—

A In Atlanta.

Q It was—he was in Atlanta at that time?

A Yes.

Q Do you recall how long your conversation with Mr. Secrist lasted?

A I think it lasted about 15 minutes.

Q Do you recall the subject of your conversation with Mr. Secrist?

A Yes.

Q And what was that?

A Well, we talked about—I think I told him that I had talked to Pat Hopper and that—on that day, and that I said that I was—I think I indicated I was investigating, that I was

looking into it, into the allegations and he—he said, "Well, you better hurry up."

I said, "Well, what do you mean by that? Have [R. 1266] you been talking to some regulators?"

He said, "Yes," and I said, "Have you talked to the insurance departments in the far west or the middle west?"

And he said, "The far east."

And he said, "And the SEC."

And—but he said he wasn't supposed to say that, this was not something he was supposed to tell me.

He was sort of hesitant about that.

Q So you understood from your conversation with Mr. Secrist that he or somebody had gone to the SEC with his information and that he or somebody had gone to some insurance department on the east coast with this information?

A Yes, I understood that, from what he said.

* * *

[R. 1279] Q On March 20, 1973 did you have occasion to speak to Mr. Herb Lawson at the Wall Street Journal again?

A Yes.

I called Mr. Lawson and told him I was [R. 1280] now in Los Angeles and I was wondering if he had had time to get started at all in his investigation.

I asked him whether he was still preparing for the Bank of America meeting and he said he was.

And he asked if I would be up in San Francisco sometime in the next few days and I told him I probably would and I would get together with him up there if I could and he said, fine.

Q Did Mr. Lawson indicate to you on March 20 that he was about to start an investigation of the allegations that you had told him about with respect to Equity Funding?

A No, he did not.

Q Did he indicate that he was about to print a story with respect to the allegations that you had passed on to him made by Mr. Secrist?

A No.

* * *

[R. 1334] Q Turning your attention to March 21, 1973 again, did you have occasion to speak to Mr. Bill Blundell on that day?

A Yes.

I spoke to him that day and I saw him that day.

Q Did you know Mr. Blundell prior to talking to him that day?

A No, I didn't know him.

Q How did you happen to speak to Mr. Blundell the first time that day?

A When I returned from my visit to Equity Funding he was—to my hotel, I received a message that Mr. Blundell had called me.

So I called him back and he said that [R. 1335] Herb Lawson of the Wall Street Journal of San Francisco had suggested that he give me a call because he—he talked to me about Equity Funding and he, Lawson, had said that the stock had been very active and dropped substantially and he wanted to come and see me.

Q What was Mr. Blundell's position in—as of March 21, 1973?

A He was the bureau chief of the Los Angeles bureau of the Wall Street Journal.

Q And in your telephone conversation on March 21 did you set up a meeting with Mr. Blundell?

A Yes, I did.

I suggested that I would be having a meeting with him at his convenience and he said he could come out to the hotel within an hour or so.

Q Did you agree to that?

A Yes.

Q Did he come to your hotel?

A Yes.

He came out and we had a meeting for an hour and a half to two hours.

Q Did you take any notes of that meeting, Mr. Dirks?

A No.

Bill Blindell [*sic*] took quite a few notes but [R. 1336] I didn't take any.

Q All right.

What did you tell Mr. Blindell [*sic*] during the meeting?

A I recited to him the allegations of Mr. Secrist in considerable detail and also told him that I met with Mr. Hopper and Mr. Majerus and I recited what they had to say in considerable detail and I told him I had been to Equity Funding and I recited to him what they had said to me about these allegations.

Q What you say in considerable detail, did you tell Mr. Blindell the allegations about the so-called Y business?

A Yes.

I told him about the allegations of fictitious assets and fake death certificates and the allegations that the company had printed up fictitious securities and that the officers of the company were purported to be engaged in this activity and the top officers of the company in particular were behind this activity.

I went through the names of all the people that Secrist had alleged to me were involved in the fraud.

I told—I showed him—I showed Bill [R. 1337] Blindell my notes representing conversations with Secrist and Hopper and Majerus and the people at Equity Funding and I gave him telephone numbers of Majerus and Hopper and Secrist.

I discussed the allegations as far as Bankers National were concerned and told him about this allegation about the sales force and all of these questions that Secrist had raised.

Q Did you withhold any information as to these allegations from Mr. Blindell?

A No.

I gave him everything I could think of at the time.

Q And was that in substance everything you knew as of the time or everything you had heard as of that time?
A Yes, it was.

Q With regard to Equity Funding?
A Right.

Q What was Mr. Blindell's reaction after you told him about all these allegations and the company's denial?
A Well, he seemed quite astonished by these allegations.
He said he couldn't understand how this [R. 1338] could possibly occur, the—he tried to question me on how this kind of an alleged scheme could—could be carried out and he said it didn't seem possible at all.

Q Did Mr. Blindell tell you he thought he could write a story based on what you told him?
A No, he didn't.

Q Did he indicate that he couldn't write a story based upon what you told him?

* * *

[R. 1339] A * * * I think he indicated to me that he couldn't do anything else he could come up with some sort of evidence or proof that these allegations had any substance and I took that to mean he was talking about writing a story.

Q Why did you tell Mr. Blindell all of this information and all these allegations?
A Well, I was hoping that he could investigate these allegations and publish a story about it, publicize the fraud if it existed.

Q And was your disclosure of this information to Mr. Blindell at the Wall Streee [*sic*] Journal an attempt to benefit your clients in the securities business?

* * *

[R. 1340] A Well, I don't think I was thinking about my clients when I decided to go to the Wall Street Journal or when I talked to Mr. Blindell.

I thought that if there were such a thing as a fraud of this magnitude, why, it would benefit anybody in the securities industry to have it exposed.

Q After you finished your meeting with Mr. Blindell did you believe that Mr. Secrist's allegations were true, Mr. Dirks?

A No.

He was a pretty experienced guy in the reporting business.

He seemed to throw even more cold water on it just by the way he was reacting.

* * *

[R. 1353] Q * * * Also on March 22nd did you have occasion to speak to Mr. Blindell again?

A Yes, I believe I did.

Q Did you call him or did he call you; how did the conversation come about?

A Well, I think I called him again.

Q You called him?

A Yes.

Q Why did you—

A Well, I further relayed back that I talked to Mr. Goldblum again that morning.

I think I was curious as to whether he was going to do or doing any checking and—

Q Do you recall what Mr. Blindell told you?

A No.

I don't really recall.

I think he indicated he—just—he was just beginning to make checks, I think.

Q Did he indicate it was based upon the additional information that you had from Mr. Goldblum he was ready to go ahead and print a story on the [R. 1354] Equity Funding allegation?

A No.

He didn't indicate that, no.

Q Did he indicate he still wasn't ready to print a story on anything to do with Equity Funding Corporation?

A I don't remember whether he indicated that, no.

He certainly didn't indicate he was ready to make—print a story.

Q And did the Wall Street Journal run any story on or about that date with respect to Equity Funding?

A No.

No, they did not.

* * *

[R. 1368] Q On March 23rd, 1973, did you have occasion to talk to the auditors or former auditors of Equity Funding or any of it's [*sic*] subsidiaries?

A Yes, I talked to two of the auditing firms.

I talked to the partners who had been or still were in charge of audits at Equity Funding.

Q And who was that that you talked to, Mr. Dirks.

A I spoked to Robert Spencer, partner at Seidman and Seidman and I spoke to Mike Balint, partner at Haskins & Sells.

Q Why did you contact Mr. Spencer and Mr. Balint?

A Well, it seemed to me that if there were any truth to these allegations, they ought to be made public as soon as possible and I remember that Stanley Goldblum had told me that the audit for 1972 had been certified and was going to be released shortly and I think he said it would probably be released the following Monday, which was the 26th, and so I felt that the best way to get this story out as soon [R. 1369] as possible, if there were any story, was to tell the auditors because they were about to certify that all the figures Equity Funding had assembled were correct figures and I felt they would have a very strong interest in—in any allegations that there was something wrong with these figures that they were about to certify.

So I felt that—and I also felt that the auditors would not only investigate very quickly, but also would—if they found they couldn't determine the truth of these allegations immediately, they would ask the New York Stock Exchange or the SEC or both, to suspend or halt trading in the stock, pending the time it took to investigate these allegations.

Q Now, when you spoke to Mr. Spencer at Seidman and Seidman, did he indicate whether he thought that the allegations you were relating to him were likely to be true or credible?

A No.

He indicated they sounded quite astonishing, incredible.

Q What about Balint, the partner at Haskins & Sells? Did he indicate that he thought that it was likely that the Secrist allegations were true or that they were credible?

[R. 1370] A No.

He was incredulous.

Q Did you have occasion to meet with Mr. Spencer in the course of the weekend?

A Yes.

I met with him on Saturday, thw [*sic*] 24th.

Q And did you have occasion to meet with Mr. Balint? during the course of the weekend?

A I also met with him on Saturday the 24th.

Q And did you relate to Mr. Balint what you had been told by the various former employees and officers of Equity Funding with respect to these allegations?

A Yes.

I spent about seven hours relating these allegations to Mr. Balint?.

* * *

[R. 1371] Q Mr. Dirks, with respect to Mr. Spencer, did you relate to Mr. Spencer the allegations which had been

made with respect to fraud at Equity Funding and the denials of those allegations by the officers?

A Yes, I did, although he didn't seem very interested in hearing them.

He seemed to be in kind of a hurry.

[R. 1372] He asked—since he didn't really have time to listen to them, whether he could make a copy of my notes and which he would keep in confidence and so I agree to—to let him make a copy which his associate did.

* * *

[R. 1376] Q Mr. Dirks, when we finished up yesterday, we were discussing the auditors and your discussions with the auditors on March 23rd and the followin [*sic*] weekend and as you recall, you testified that you had brought this information and allegations to the attention of Messrs. Balint and Spencer.

Why did you go to the auditors at that time, Mr. Dirks?

A Well, my objective was to try to determine the truth of these allegations and to publicize them and it occurred it had occurred to me that the—that the top management of Equity Funding had just told me that the auditors had certified the annual statement for 1972, and that they were about to release that certification publicly probably the 26th.

This was the 23rd, Friday afternoon, and that one way to try to get to the bottom of this was to present these allegations to the auditors and with the—my feeling [R. 1377] was that they would immediately look into them if they thought—if the allegations had any—any—even if they didn't have any real credibility on the face of it, they at least would have to make some investigation because of the magnitude of the allegations, and I felt that—I also felt that they would immediately notify the stock exchange and the Securities and Exchange Commission about the allegations and stop trading in the stock and that this would also serve to bring this thing to an immediate head in the sense that once the trading was halted, there would be—it would be important from everybody's standpoint including the company's to—to cooperate in pinning down whether there was anything to these allegations.

* * *

Q Mr. Dirks, did you have any impression or any [R. 1378] view as to whether your going to the auditors over the weekend following Friday, the 23rd, would have any impact on the trading in Equity Funding stock?

* * *

A It was my believe [*sic*] after I had talked to the partners of Seidman and Seidman and Haskins & Sells, specifically, that they were going to look into these allegations and that they were going to notify the New York Stock Exchange and the SEC about the—about the allegations and it seemed to me that in view of that, the stock would not open for trading because I didn't see how they could resolve this over the weekend.

It would take—it seemed to me it would take a day or two, at least, for them to look into it and so [R. 1379] I didn't think the stock would trade at least on Monday, Tuesday.

Q And on Monday the 26th, of March, did you find out whether the stock did open and did trade?

A Yes.

Shortly after ten a.m., New York time, I found out that the stock was trading.

Q And did the fact that the stock was trading on Monday, the 26th, lead you to any conclusion with respect to the likelihood of the veracity of the Secrist allegations which you had related to the accountants?

A Well, that made me further doubt the veracity of the allegations.

It appeared to me the auditors hadn't considered them to be at all worthy of serious investigation.

* * *

[R. 1381] Q * * * Now, Mr. Dirks, on Monday, March 26th, did you have occasion to speak to Mr. Blundell of the Wall Street Journal?

A Yes, I did.

Q How many times did you speak to Mr. Blundell during the day on March 26th?

A I spoke to him several times and I spent several hours with him personally.

Q Do you recall what time of day your first phone call was?

A As I recall, the first phone call I made to him was around 10:30 in the morning.

Q And do you recall what you said to him or what he said to you in the course of that conversation?

A I said to him that I had just run out of my hotel and I was in a state of panic because I had just learned from Mr. Ronchetti that the notes I had turned over to Seidman and Seidman on Saturday were in the hands of the top company officials at Equity Funding, and so I asked him if he could do something to help bring this to a—[R. 1382] to a head because apparently the accountants were not taking it at all seriously and I wondered if he could do something, perhaps publicize these allegations or something of that sort.

He said that he—he said, well, first of all, you know, a good reporter never turns over his notes to anybody, and he didn't know what he could do at that time, but that he would see what he might be able to do and to keep in touch with him.

Q This was all—that was said during the first conversation on the 26th with Mr. Blundell?

A That's right.

Q Did you have a later conversation with Mr. Blundell on the telephone on the 26th?

A Yes.

I talked to him again in the afternoon, I think around three o'clock or so.

Q And do you recall what was said in that conversation?

A Well, I asked him if he had been able to do anything.

He said no, he couldn't publish anything or write a story about it, but that he was in touch with the SEC and he won-

dered if I would be willing to meet with the SEC and I said I would, under his auspices, or based on his [R. 1383] introduction.

Q Did he tell you why he couldn't publish the story?
A Well, he said he still didn't have enough to go on, something to that effect.

Q Did he tell you who he had been in touch with at the SEC?
A I don't think he named anybody.
He said the three SEC people from the Los Angeles branch office were going to be coming over to his office in a little while and he wanted to know whether he could ask them if they wanted to meet with me and also with Pat Hopper and Frank Majerus, and he asked—I believe he also asked Pat Hopper who was with me at the time, if he would be willing to meet with them and he said he would.
So he said he would call me after the meeting—call us both after the meeting and let us know whether the SEC was—would want to meet with us.

Q Did he call you later?
A Yes.
He called later and said he had a meeting for about an hour with these three people from the SEC, and that they had said that they would be willing to meet with Hopper, Majerus and me, and I believe he gave—gave us the telephone number of Gerald Boltz, B-o-l-t-z, who was the—the head of the Los Angeles office of the SEC, to [R. 1384] call him at home.

Q Did you meet with Mr. Blundell later in the day?
A Yes.
After another couple of hours, we talked again and we decided to meet down at the—downtown near the Sheraton Hotel on Wilshire which we did.
That meeting included Pat Hopper, Bill Blundell and myself and we talked for several hours about this whole situation.

Q By "this whole situation," you mean the allegations with respect to Equity Funding?
A That's correct.

Q At this time, had you told Mr. Blundell everything that you had by way of allegation or information with respect to Equity Funding Corporation?

A Well, I think I had told him everything I knew as I received the information, but whatever—whatever was happening, whatever information I had and whatever I was—whoever I was talking to, I relayed all that to Mr. Blundell so by that evening certainly I had told him everything I knew and I was trying to see what he was doing.

He indicated that he had talked to all the people I had talked to and also some additional people.

Q And he told you that isn't—wasn't enough to [R. 1385] print a story?

A Yes.

He told me he still couldn't print a story about it.

Q After you had gotten Mr. Boltz's phone number from Mr. Blundell, did you call Mr. Boltz?

A Yes.

I called him immediately or at least I called him—I called him when I was told by Mr. Blundell that he might be home anyway, and I believe Pat Hopper actually called him and we both agreed to meet Mr. Boltz at the SEC the following morning, I think at nine o'clock, around that time.

Q And did you go down to the SEC on the morning of March 27th?

A Yes, I did.

Q And did you go voluntarily, without subpoena?

A Yes, that's correct.

Q And did you thereafter, before the SEC, testify with respect to the Equity Funding allegations?

A Yes.

I testified that day and for the next three days in Los Angeles.

* * *

[R. 1388] Q * * * Did Mr. Blundell of the Wall Street Journal tell you that he had contacted the SEC on Friday, March 23rd?

A Yes, he did.

Q When did he tell you that?

A I don't recall exactly.

It was sometime during that period I learned that he had called the SEC or that Herb Lawson had called the SEC on Friday.

Q Do you know who Mr. Blundell or Mr. Lawson called at the SEC on Friday, March 23rd?

A Yes.

It was Stanley Sporkin, I believe.

I'm pretty sure they called—yes, they talked to Mr. Sporkin.

Q Did Mr. Blundell or Mr. Lawson tell you whether they had relayed the Secrist allegations to Mr. Sporkin on Friday, March 23rd?

A Yes.

They told me they had briefly relayed these allegations.

Q Did the SEC call you on Friday, March 23rd?

[R. 1389] A No, they did not.

Q Did the SEC attempt to contact you on Saturday, March 24th?

A No, they did not.

* * *

Q Did the SEC contact you on Sunday, March 25th?

A No.

Q Did the SEC contact you on Monday, March 26th?

[R. 1390] A Well, I contacted them.

Q Thank you.

Mr. Dirks, what was your motivation in doing your investigation of the allegations with respect to Equity Funding?

A My motivation was to publicize the fraud if it existed and first to determine whether there was any truth to the allegations and in doing so, it became apparent that I had to talk to a lot of people and make—and publicize it as much as I could.

My motivation was to having heard these allegations from a former employee of Equity Funding, to try to determine the truth of them and in doing so, to—to publicize them and expose the fraud, if it existed.

Q Why did you want to expose the fraud if it existed? Why did you want to publicize it?

A It seemed to me it was—if there were truth to these allegations, it was a very—it was a very criminal thing going on that was going on underneath the noses of the regulators and it was hurting the public, it was hurting the securities industry and the insurance industry and it was something that was, if the allegations were true, was not only going on, but it seemed to be increasing in scope and it would have eventually involved other companies, that Equity [R. 1390a] Funding was already trying to acquire and said they were going—had indicated they would continue to acquire.

So it was something that had to be investigated immediately it seemed to me.

* * *

[R. 1403] Q In the course of your direct and cross-examination during the past few days Mr. Dirks, have you mentioned a number of companies and persons to whom you related all or a portion of the allegations with respect to fraud at Equity Funding?

A Yes.

Q Are there any other companies to which you related these allegations?

* * *

[R. 1404] A Well, there were quite a few others.

There was Chemical Bank, Schroeder Trust Company, Ford Foundation, Morgan Guaranty Trust Company, Steinhardt, Fine and Berkowicz.

There was Fidelity Corporation of Virginia.

There was McConnell and Miller.

There was Smith Barney Bayrock Advisers.

There was Standard & Poors, Oppenheimer and United Bank of Madison, which—Madison, Wisconsin.

There may have been others.

Those are what I recall at this moment.

Q Did you mention Loew's Corporation?

A No, I thought we had discussed Loew's previously. I did certainly talk to Loew's at great length.

[R. 1405] Q Was Loew's Corporation a client?

A No, they were not a client of Delafield Childs.

Q How about Fidelity Corporation of Virginia, were they clients?

A No.

We never did any business with them.

Q How about Bayrock Advisers, were they a client?

A No.

We never did any business with Bayrock.

Q How about Oppenheimer, was Oppenheimer a client?

A They were competitors.

Q How about the Steinhardt firm, were they clients?

A No, they were not.

Q How about Smith Barney, were they a client?

A No.

They were competitors.

Q How about the Ford Foundation?

A No.

Q Were they a client?

A No.

[R. 1406] Q How about the United Bank of Madison?
A No, they were not a client.

Q Did these people pay you for anything that you told them?
A No, they never did.

Q Did you expect them to pay you for anything you told them?
A No.

Q Did you expect them to become clients after anything you had told them?
A No.
I didn't think they would.

Q Did you, in the course of your investigation give a different story or give different portions of the allegations to people you spoke to depending on whether they were clients of yours or not?
A No.

Q Mr. Dirks, why didn't you go to the SEC before Tuesday, March 27th?
A Well, in the first place I heard the allegations from Mr. Secrist.
We discussed the regulators and specifically the SEC.
He indicated that several people at Equity Funding had talked to the SEC and that this [R. 1407] has not resulted in any serious investigation.
In fact, that the employees felt that the allegations had come back to the top management of Equity Funding was committing a fraud and secondly—then I expressed to Mr. Secrist at the time that I personally had similar experience with the SEC wherein I had related them information that was confidential and that this confidential information had been relayed by the SEC to business clients of mine which had resulted in my losing their business.
And consequently I agreed with Mr. Secrist that his idea that he would not personally go to the SEC was probably wise

under the circumstances and I indicated to him that I would not got to the SEC myself, rather I would go to the Wall Street Journal.

* * *

[R. 1665] Q Mr. Dirks, do you recall that on Monday, the 12th, you asked somebody at your firm to check your records to see which of your clients owned Equity Funding securities?

A I don't recall that.

Q Do you remember giving testimony before the New York Stock Exchange on April 4th, 1973?

A Yes.

MR. BONDERMAN: Do you have a page number?

MR. DEITZ: Page 36, Mr. Bonderman.

BY MR. DEITZ:

Q Do you remember being asked the following questions and giving the following answers:

Would you read outloud from page 35 with the question beginning "You also".

* * *

A "Question: At your lunch, you know, prior to talking to this individual, did you discuss Equity [R. 1666] Funding?"

"Answer: No."

"Question: You also mentioned that one of the things you were going to do was check the list to see if any of the clients had any of the stock?"

"Answer: Right."

"Question: Did you have that done for you on Monday?"

"Answer: I think I asked somebody to check our records, but I don't recall at what time during the day.

It had to be sometime before, I think, around 4:30."

"Question: And what was determined, that clients did have them?"

"Answer: It was determined that no mutual fund owned it, to my knowledge, because they were not allowed to own it.

"We keep a cross reference. The only way we could determine who owned it is because we checked with the client, we tried to ascertain what he owns, and I had my secretary record the names of their holdings in the file of that client.

"I also had her transfer the individual's holdings to a sheet which shows the names of the institutions [R. 1667] that own one stock, and so we checked that.

"I think there were three names or four. I'm not sure."

"Question: Can you recall the four names?"

"Answer: I'm sorry, but I think there were three.

"There was Boston Company, Institutional Capital and Sears Roebuck, but I should have mentioned earlier as regards when this individual came to me, I recall specifically one conversation I had had with an institution about it and I don't have to go to my records for that.

"I knew that there was one company that owned that stock and that was Boston Company and I'm not sure if I checked the records on Monday.

"In other words, I'm not a hundred percent sure, but I think I did.

"I must have."

Any more?

Q That's fine.

Do you remember being asked those questions and giving those answers, Mr. Dirks?

A Well, I remember being called in there on April the 4th to answer a lot of questions.

I think they were in a big rush and I was in a big rush, and when I used terminology like owning stock, it [R. 1668] was certainly not—that may have been the standard type of terminology when you talk to clients, because I explained to you earlier, Mr. Deitz, we didn't know who owned stocks.

Generally we ascertained whether they had an interest in them.

The institution doesn't normally say, well, we own this, we own that.

Generally they reflect that they have an interest, they may own it, they may have owned it and sold it, they may not own it and be interested in buying it.

* * *

[R. 1764] Q Why did you use the word "owned" instead of had an interest, in the book?

You are fairly consistent.

A Well, I—

MR. BONDERMAN: Excuse me.

I would like to object here on this.

[R. 1765] It seems to me, your Honor, that we spent most of the morning on this exact subject and the same exact thing.

Mr. Deitz has already had this question answered several times.

I don't think we would like to go through it again.

MR. DEITZ: Your Honor, it is a question that hasn't been asked yet.

I confronted the witness with inconsistent statements.

He told me in each of these instances that what was printed, owned, Mr. Dirks indicated to mean to have an interest.

I wondered why, and haven't asked him yet, why they used in the book—or—he used in the book the word owned instead of had an interest.

JUDGE MARKUN: Well, gentlemen and ladies, I think in point of fact that the question has been asked, perhaps not in those words, but in substance at least once by counsel and at least once by me.

However, I have not heard an answer that I can comprehend, so I am going to allow the question to be put to the witness one more time.

Will the reporter read the question back, [R. 1766] please.

(Record read.)

A Well, I think that's precisely the reason that Mr. Gross wrote it that way, because it is confusing that—I think, to the layman reader of a book about a pretty complicated event relating to the stockmarket, which very few people know much about in detail.

Rather than use have an interest and owned there, it seemed to me that that's the reason that it was used.

I didn't—I didn't see that that was a significant point to change just because it wasn't strictly true.

In other words, when I was reviewing the galleys or the initial pages of the book, as drafted by Mr. Gross, I thought that that was a literacy license in the sense that it was something that would make it clear to the reader.

JUDGE MARKUN: Did you consider the question of fairness to your former, current or potential clients in terms of being accurate, the difference between having an interest and owning?

THE WITNESS: No, I don't think I considered that at the time.

Q Why in these conversations did you ask at all [R. 1767] whether your clients either had an interest in or owned Equity Funding before telling them about what you had heard from Mr. Secrist and others?

MR. GREENWALD: Your Honor, I object.

We have had hours of testimony about the fact on the street, and I think everybody in this room who has any familiarity with the way investment advisers work, they do not announce—and this has been testified to; I'm not—they do not announce what they own.

They announce what they have an interest in.

Now, for Mr. Dietz at this point to ask this witness why didn't you ask them, when the witness has at least on a half dozen occasions indicated that that's not the way it is done, it seems to me, it is highly repetitious.

That's why we are spending so much time with this witness.

MR. DEITZ: Mr. Greenwald, you are objecting to a question that I did not ask.

JUDGE MARKUN: Well, I'm not sure that you got the drift of the question.

I'm going to ask the reporter to read it to you.

[R. 1768] (Record read.)

MR. GREENWALD: You are right, your Honor, I didn't get the drift of the question.

I don't understand it at all.

Laughter.

MR. GREENWALD: I don't have the foggiest idea of what Mr. Deitz is referring to.

I would object to the question on that basis.

MR. TANDET: Your Honor, I would also object because it was not testified to before by Mr. Dirks in the form that that question is asked.

JUDGE MARKUN: No.

I think, sir, to the contrary, there is at least some evidence indicating that he asked—he asked at least whether the client had an interest in Equity Funding.

So that part of the objection is clearly not well taken.

As to Mr. Greenwald's objection, that the question is unclear, I think it is clear in my mind.

I'll have to ask the witness, do you understand the thrust of the question?

THE WITNESS: Well, your Honor, I—

[R. 1769] JUDGE MARKUN: He's asking you why you asked either about an interest or ownership on the part of the persons you were contacting.

THE WITNESS: Well, I think I understand the question.

JUDGE MARKUN: All right.

Let us have your answer, please.

A In the first place, though, I don't believe I did ask in every instance whether they had an interest in the stock.

But in the cases where I did, I asked the question to see whether—well, as I have testified to, you don't really want to waste time of people who are busy in the investment world trying to invest money with securities they have no interest whatsoever in.

The inclination would be that they would spend a few minutes talking to you about the security.

That would be the reason for asking that question.

JUDGE MARKUN: But in this particular context, Mr. Dirks, you wern't [*sic*] inviting them to purchase the stock, were you?

THE WITNESS: No, I was not.

I was inviting them, your Honor, to listen [R. 1770] to these allegations and see what their reaction was to it.

And also as I testified earlier, your Honor, to see whether they would make checkings themselves in view of the greater resources they had, see whether they could come up with anything to substantiate these allegations.

* * *

EXCERPTS OF TESTIMONY OF GERALD ZUKOWSKI

[R. 1957] GERALD ZUKOWSKI,

* * *

Q Where are you employed?
A Boston Company Institutional Investors, Inc.

* * *

[R. 1959] Q Now, what is your position with III?
A My title is vice president.
I basically am a portfolio manager.

* * *

[R. 2276] Q Mr. Zukowski, I hand you Division Exhibit No. 24, which is a Xerox copy of a document.
Do you recognize that?
A Yes, sir.

Q Can you identify that document for us?
A This is—we had a chit system where you could put in for brokerage commission business to be given to a broker.
And this was a brokerage request in which I wanted to give Dirks four or five thousand dollars of commission business and I had—do you want me to go over this?

Q Why don't you read for the record?
A Yes, sir.

Q One item under reason, which is part of this division's exhibit.
[R. 2277] A Insurance company reports and recommendations.

Q Now, did you write that on this exhibit or cause that to be written on that exhibit?
A Yes, sir.

Q And did you direct Mr. Moore to execute this brokerage request somehow or did you prepare it yourself?

A I prepared it and it had to be approved by Tom—it was the first one I had ever prepared.

Q In the lower right hand corner it says approved by and it looks like initials of TC.

Is that Tom Courtney's initials?

A I believe so.

MR. MALAWSKY: I offer Division Exhibit 24 in evidence.

* * *

Q Now, in the lower left hand corner, requested by, is that your initial?

A Yes.

[R. 2278] Q On Division Exhibit 24?

A Yes, sir.

Q And the date appearing on the brokerage request, Exhibit 24, 31573, in the amount of $3,956.20.

A Yes, sir.

Q Now, can you explain the date and the—that amount that I just mentioned, how did that come to appear on that exhibit?

Q Yes.

The trader wrote that on there.

That was the—I would assume that he evidently transacted—made a transaction on that date for that exact amount.

Q Would you know what securities would have been the ones sold or purchased which would have generated those commissions?

A Well, at the time I got my first account and I was selling things left and right that would have probably been from one of the sales I made, but I am not certain.

Since I just gave the request to the broker—we don't have any strict policy on giving a broker—sales or commission business on a particular stock.

We bought a lot of—combustion engineering based on Delafield—Delafield analysts and we didn't [R. 2279] buy it all through them.

Q The item on the Exhibit 24, it says amount, four to five thousand, that would be dollars.

A Yes, sir.

Q Was that your request that he get commission business of four to five thousand dollars?

A Yes, sir.

Q And you write in firm Delafield Childs, correct?

A Yes, sir.

* * * *

[R. 2362] Q Will you tell us what was said?

A I did not want to talk to Ray.

I had two or three comments with Ray.

Ray asked me—he said—he says, you know, I'm liable to go bust on this thing, are you going to pay that commission business that you promised and I said, everything is totally out of my hands.

I said I don't know and I didn't want to talk [R. 2363] with him.

I didn't want to be there.

Q Was this in reference to the $25,000 business?

A We didn't say the amount.

He said the amount you mentioned—he may have, but he referred to the commission business that I promised him.

* * *

[R. 2366] Now, I think the understanding was that I would be able to pursue this area over his standing objection.

Since Mr. Bonderman is not here today I am raising this with you so the record will be clear.

* * *

EXCERPTS OF TESTIMONY OF LEO GOLDNER

[R. 4443] Good afternoon, Mr. Goldner.

Thank you for being with us.

State for the record your full name and present address.

A Leo Goldner, Edgewood Drive, Portchester, New York.

Q Where do you work?

A At Merkin & Company.

Q What sort of business is Merkin & Company in?

A Brokerage business.

Q What is your position there?

A I am a registered representative.

Q How long have you been in the securities business?

A 19 years.

Q Were you a registered representative in March 1973?

A Yes.

Q With what firm were you registered?

A Sweikart.

Q In the period March 6, 1973 through March 27, 1973 that would be through and including the time that trading in the security was suspended, did you make any purchases of any securities issued by the [R. 4444] Equity Funding Corporation of America?

A Yes.

* * *

[R. 4453] Q At the time you made 1,000 share purchase on March 26 did you have an impression about the financial condition of Equity Funding Corporation of America?

A Yes.

Q What was that impression or belief?

A That it was a company that was growing very rapidly and that the earnings for that year should be up appreciably

over the year before and that it was very solid insurance company.

* * *

[R. 4457] Q Mr. Goldner, as you sit here today do you recall whether on or before March 26, 1973 you heard any rumors from anyone in the world to the effect Equity Funding or any of its subsidiaries were being investigated by a government regulatory agency?

A The day I bought the stock?

Q Yes.

A No, I didn't hear any rumors before I bought the stock.

Q All right.

At the time you bought the stock were you informed Equity Funding was having accounting problems of any kind?

A No.

[R. 4458] Q At the same time, were you informed that Equity Funding had issued and was carrying on its books and records, fictitious life insurance policies and supporting records relating to such policies?

A No.

Q At the same time, were you informed that Equity Funding had been carrying on its books and records fictitious assets and earnings?

A No.

Q At the same time, were you informed that Equity Funding had publicly issued false and fraudulent statements of insurance premium income?

A No.

Q At the same time, were you informed that Equity Funding had publicly issued false and fraudulent financial statements?

A No.

Q At the same time, were you informed that officers and employees of Equity Funding had engaged in the fraudulent schemes and course of conduct described in my previous set of questions?

A No.

Q Had you been informed of one or more of those alleged improprieties, would you have purchased Equity Funding securities in March, 1973?

[R. 4459] A No.

* * *

[R. 4502] Q In March of 1973, up until that time, you had sold short stocks on four or five occasions?

A I follow you.

Q And you had definite reasons for selling short—

A Yes.

Q —instead of having a stock long, isn't that correct?

A Yes.

* * *

[R. 4503] Q Well, then let's go into that a bit, Mr. Goldner.

What are these handfull of stocks, these four or five that you referred to?

Which ones did you sell short?

A I don't have the foggiest idea.

Q You don't recall?

[R. 4504] A No.

Q And is that because you have traded in stocks so often that you don't recall these four or five instances you sold short?

A In 19 years I bought and sold a lot of stocks, yes.

Q For yourself and for others, isn't that correct?

A Yes.

Q And in any of those times that you sold, you—had you heard any rumors about a stock before you sold it?

A Yes.

Q And did all these rumors turn out to be true?
A No.

Q And did you go tell the broker or the prospective purchaser this rumor that you heard?
A I'm sure at times I did and at times I did not.
The prospective purchaser?

Q Yes.
A I'm sorry, sir.
You are really going around the bush.
Look—

[R. 4505] Q I am trying to go right to the heart of things, Mr. Goldner.
Maybe you are going around the bush.
A Look, I will answer your question.

Q Thank you.
A What I was—what I was trying to say is that the way the market system is structured here, you don't meet the buyers of your stock and you can't physically go on the floor because these are unknown people to you, unless you do a great deal of checking to find out who they are.
And when you are buying and selling stock a lot, you do not know who is buying your stock.
It is a very impersonal thing.
So regardless of who or how I feel philosophically about that statement, in a practical matter you can't tell the buyers of the stocks the rumors because you don't know who they are, which is the point.

Q And there is no way you can even get it conveyed to any prospective purchasers, is there then?
A Yes, you can.

Q How?
A By informing your broker in the floor [R. 4506] why you are buying the—or selling this stock how—so that they can tell the other party the reasons you are buying or selling it.
If you feel that is important to do.

Q And have you done that in all instances when you sold stocks based on rumors?

A No, I have not.

* * *

[R. 4507] Q Is it fair to say that in the securities business there are frequently rumors about securities and companies?

A Yes.

Q And do a lot of these rumors turn out to be baseless?

A Yes.

Q Can you think of a time in your 15 years, 19 years, in the securities business, where prior to sale or purchase of a security, disclosure was made to your broker and asked him to disclose to the contra-broker a rumor which you had heard of the company?

A I said I haven't done that.

Q Is it common for people in the securities business who hear rumors about companies to try to get them published before they trade?

A You mean if someone hears a rumor, they should ask that the company publish that information or someone publish it before they act upon it?

[R. 4508] Q Is that common, yes, to your knowledge?

A It is becoming more common.

Q Was it common in 1973?

A No.

* * *

[R. 4509] Q Mr. Goldner, on occasions when you heard rumors about a company, did you ever report those rumors to the SEC?

A No.

I would be on the phone all day probably.

Q That's because there are so many rumors floating around in the market?

A Many, many rumors, yes.

Q And that was true in March of 1973, wasn't it?

A Yes.

* * *

EXCERPTS OF TESTIMONY OF MALCOLM MACKAY

[R. 6654] MALCOLM MACKAY,

* * *

[R. 6656] Q Would you tell us, please, who constituted the hierarchy of the New York State Insurance Department in March of 1973?

A Yes, sir.

The superintendent of insurance, who is the first person in the department, was Benjamin Schenck.

I was the first deputy superintendent, which I think you could roughly describe as the chief administrator of the department.

* * *

[R. 6670] A I don't remember whether—whether it was on the 7th or the 8th that Mr. Krowitz and I discussed the matter.

Others and I discussed the matter.

We decided that we should inform the California and Illinois Departments of Insurance.

As I recall now—and this is vague—Mr. Secrist came to us in strict confidence, and we felt that we had to contact him and receive his permission before we contacted the California and Illinois Departments.

I think we did that starting on the 7th but had trouble finding him.

That was my recollection.

So I assume that on the 8th we did receive permission and we called the California Department, Mr. Christy Armstrong, whom many of us have had contact with.

And he called the Illinois Department.

You are dealing, basically, with an Illinois company doing 40 percent of its business in California.

That's why we chose that route.

* * *

EXCERPTS OF TESTIMONY OF ROBERT BERTRAND

[R. 6817/6818] ROBERT BERTRAND

* * *

[R. 6819] Q And prior to your going to private practice, what did you do?

A I was a Deputy Superintendent of insurance for the New York State Insurance Department.

* * *

[R. 6829] A I recall my concern at the time was whether or not what Secrist was telling the department was, you know, reliable, whether he was reliable.

I recall asking specifically whether he was credible, whether his story was believable and so on.

And I recall Mr. Krowitz telling me that they had taken him back and forth and around and around and he had always come out in the same place.

The crux of it was that the bureau staff was convinced that he was telling a real story, that it wasn't—that he was not making it up or imagining what was going on.

* * *

[R. 6851] Q * * * Now, did you have anything to do with calling Christy Armstrong?

A Yes.

After the events that we talked about earlier on March 6 and March 7, and further discussions that we had in the department—

Q Now, who is "we"?

A I would say the bureau staff and myself.

Q Who would that consist of?

A Mr. Krowitz, perhaps Mr. Alpert, and I don't know who of Krowitz' subordinates were actually involved in some of this day-to-day stuff.

But I recall clearly that at least Krowitz and I were involved in determining what we should do next.

And in view of the fact that Equity Funding Life was—had its principal offices in California, we made a decision to notify the California Insurance Company—Department, because they were on the scene and because we were very well acquainted with Christy Armstrong and the kind of person he was and so on.

So we telephoned Christy Armstrong or I believe Mr. Krowitz did, after it was decided that [R. 6852] this was what was going to be done, to apprise Armstrong of what the situation was.

Or what we knew of the situation.

Q To give your version of how—or what—at least Mr. Krowitz' version of what Mr. Secrist had said?

A That's correct.

Q That's correct?

A That's correct.

Q And were any opinions given at that time as to the truth or falseness of what Mr. Secrist had said, if you know?

A I don't know if any opinions were given.

I do know, however, that the feeling in the department at that time was that we thought Secrist was telling us the truth.

* * *

[R. 6928] Q Mr. MacKay testified yesterday in response to a question by me that he did not alter his view that the Secrist allegations represented an incredible, but theoretically possible set of facts until sometime in April of 1973.

In light of that testimony by Mr. MacKay, would you have a judgment as to the earliest date on which it was your view that the Secrist allegations were not only possible but probably true?

A I think I felt that way the afternoon of the 7th when I had a conversation with Mr. Krowitz.

* * *

EXCERPTS OF TESTIMONY OF JAMES STEEN

[R. 6972] JAMES STEEN

* * *

[R. 6974] Q What was your title or position when you were so employed by Illinois?

A Initially I was Deputy Director of the examinations branch, and then—that was from October of 1972 until July of 1973; from July of 1973 until December of 1974, I was Deputy Director of the financial regulatory branch.

* * *

[R. 6989] We decided to send a team of examiners in to the—into Equity Funding Life Insurance Company on Monday, March 12.

* * *

[R. 7002] Q Now, why was Mr. Doyle selected to go to California?

A He was one of our senior examiners and probably the best field examiner in the life division [R. 7003] of the examinations branch.

Q What about Mr. Fowler, who you also said you spoke to on March 9th?

A Fowler had been a field examiner working on actuarial matters and had since been transferred to the Springfield office to work on actuarial matters from within the office.

* * *

[R. 7035] JUDGE MARKUN: What was that policy?

THE WITNESS: In this case, we determined that we were going to investigate under the guise of a routine examination and if there turned out to be substance to what he had been told, to the allegations, then we would make them known.

If they turned out to be without substance, then we would issue our regular routine examination report.

* * *

[R. 7081] Q By the way, Mr. Steen, with respect to a company of the size of EFLIC, how long would it normally take to do a routine examination?

A A month to two months probably depending upon the manpower that was directed to it.

* * *

[R. 7088] Q Isn't it a fact that Mr. Secrist sounded rational and was believable during the course of your conversation with him on March 21st?

A Yes.

Q Did you gain the impression from his remarks and statements about the fraud at Equity Funding that he knew what was going on?

A He seemed to.

* * *

[R. 7097] Q By the way, by March 23rd there was no discussion about discontinuing the examination, was there?

A Discontinuing the examination?

Q Yes.

A No, not at all that I can recall.

Q In other words, on that day, or certainly by that day, was—it was ever the intention of the department to continue the investigation until you either found something wrong or you confirmed that nothing was wrong, is that correct?

A And issued our regular routine report, that's right.

* * *

EXCERPTS OF TESTIMONY OF CHRISTY ARMSTRONG

[R. 7252] CHRISTY P. ARMSTRONG

* * *

Q Your position with the California Department of [R. 7253] Insurance?

A I am the chief insurance examiner.

* * *

[R. 7291] Q Now, Mr. Armstrong, referring to this single page of notes of Exhibit CC on the 9th when you talked with Mr. Steen, do you remember having some discussion with him about how California would interface or interact with Illinois in this examination?

A Well, I recall that we tried to plan some strategy in that Illinois would come in first and then we would send a man on later so that it wouldn't appear that we just were jumping on this company with a ton of bricks, so to speak.

Q What was the reason or theory behind the planning or strategy for making this examination, as you [R. 7292] recall?

A We didn't want to alert the company for fear that they might start destroying records.

Q You wanted to make the examination appear as routine and ordinary as possible?

A Yes, we did.

Q That was to conceal from Equity Funding any basis for suspicion on their part that you were aware of these allegations?

A That was our strategy.

Q This was the strategy that you worked out with Mr. Steen?

A Yes.

Q Did you on the 9th indicate to him a date on which California would join in the examination?

A As I recall, I said a week or 10 days after the men were there, we'd have Mr. Rouble represent this state in Zone 6.

* * *

[R. 7424] Q Mr. Armstrong, do you normally keep penciled notes of every known conversation you have during the course of your official duties at the California Insurance Department?

A No, I don't.

Q May I ask you then what prompted you to keep the notes which with a few exceptions represented typed or printed III Exhibit Z to BBB?

A Actually, there are two reasons. One, because I had prior dealings with Mr. Goldblum who was the number one man in the organization and I had reason to question his integrity and the second was that the source of the information, that is, from Mr. Krowitz, led me to believe that this would develop into a case in which there would be litigation. So that the answer to your first question really is that if I find that we are going to be involved in litigation, that is, seizure, I try to maintain fairly complete notes.

* * *

[R. 7432] Q When you heard the allegations the first time from Mr. Krowitz, did you have an impression or a reaction as to whether the alleged scheme was technically feasible, given what you knew about the life insurance industry at that time?

A Yes, I reached the conclusion it was feasible.

* * *

[R. 7453] Q Could California have conducted a routine regular examination?

A Yes. We have the authority to do that.

Q Of EFLIC?

A Yes.

Q Were the procedures for a triennial or routine examination by Illinois officials substantially the same as those California followed?

A Yes, they are.

Q And were the procedures in either or both jurisdictions such as would have in your opinion uncovered the kind of fraud that Secrist alleged to have existed at EFLIC if there hadn't been some sort of informant such as Secrist or other employees?

A Yes. I believe we would have found at least a shortage of assets. There's no doubt in my mind that we would have uncovered the assets.

* * *

[R. 7454] Q But apart from the shortage or actual absence of assets of that kind the routine examination would have uncovered, would it have uncovered the matter of bogus insurance, assuming that the records were adequately falsified?

[R. 7455] A That would have naturally followed. The fact that the assets were not there, why—the question would be: Why did the company create such an asset on its books? And it would have naturally led to this operation in my mind. There's no doubt in my mind that in the course of a normal examination we would have found both the absence of the assets and the fact that the reinsurance was—that the business in force and the reinsurance on it was absolutely bogus.

* * *

EXCERPTS OF TESTIMONY OF LAWRENCE BAKER

[R. 7457] LAWRENCE COLBY BAKER

* * *

[R. 7458] A * * * In 1971 I was appointed as chief deputy insurance commissioner for the State of California.

* * *

[R. 7528] Q What was your state of mind by the end of that week, the 23rd, about the allegations of Secrist?

A It seems to me that there was a growing likelihood there was something seriously wrong at Equity Funding and there might well be some kind of fraud going on.

* * *

EXCERPTS OF TESTIMONY OF EDWARD GERMANN

[R. 7595] Q Would you state your full name and home address for the record, please.

A Edward Germann, 18725 Covello Street, Reseda, California.

Q Your business address, Mr. Germann?

[R. 7596] A 600 South Commonwealth, Los Angeles. California Department of Insurance.

Q Will you tell me what your present position is with the California Department of Insurance.

A Division Chief, Surveillance and Analysis Division.

Q How long have you held that position?

A Since about 1966.

* * *

[R. 7645] Q Did you have a conversation with anyone else on the 8th of March relative to Equity Funding?

A No.

Q Let's turn to the 9th then.

What do you remember as to any conversation on the morning of the 9th.

A I probably called Immigration and checked up on the passport there.

Q After that?

A I got a call from Mr. Bertz by—or I phoned Mr. Ogg and set up a time to come over to the SEC which was about 2:00 o'clock.

Q Did you go over to see Mr. Ogg at 2:00 o'clock then?

A Yes.

Q Where did you meet with him?

A In his office.

* * *

[R. 7646] Q Was anyone else present when you met with Mr. Ogg?

A Not at the beginning.

Someone—one or two people came in near the end and sat down.

Q How long did the meeting last?

A 45 minutes.

Q When during the 45 minutes did anyone else join you and Mr. Ogg?

A I would say maybe a little after 2:30.

Q After the first half hour?

A Yes.

* * *

[R. 7647] Q Was that the first occasion you ever met Mr. Ogg face to face?

A Yes.

The first time I think I had been to that end of the building.

Q Would you tell me in as much detail as you can exactly what you said to Mr. Ogg with reference to the allegations you had heard the previous day about Equity Funding?

A Well, I told him we had this report from someone who—we had this report from the New York Department that some employee from the New Jersey company had come in to say that there were things going on in the company that were not right and that it took the form of faked policies, falsification of confirmations about mutual funds or falsification of mutual funds and that there was faked bank certifications.

That was essentially what I told him.

Q Excuse me—

A And that these people were getting ready to leave the country, the report we had, and started to get sticky.

Q With reference to your report to Mr. Ogg on [R. 7648] faked insurance policies, did you discuss or mention the reinsurance aspects?

A Yeah.

Q What did you say about that?

A Well, that they had this thing where they would reinsure them up to the other companies and make it appear that they had written them, to make it appear that they were doing a lot of buisness and get the commission, 160 per cent commission, that O'Regan and Armstrong had talked about.

I told him too that there was some fellow with a name like Wieland that has a file, some kind of a file or tape that we ought to try to find, to explain how it was done.

Q What did you say to him about this fellow named Wieldnad or something like Wieland?

A That he supposedly had a piece of evidence somewhere.

I wasn't sure what it was and wasn't even sure how to spell his name or what it was, but it was a name like Wieland.

Q Did you identify it as a tape that he had?

A I am not sure whether I called it a tape or what.

I know I talked about it because it is easy to [R. 7649] remember the Y file and Wieland.

Q Did you refer to it as the Y file?

A Yeah.

It was called the Y file.

That was the only thing I knew it by at the time.

Q Did you tell him anything about whether you understand where Mr. Wieland might be located?

A I know my notes say "L.A.," but I carry him out of West L.A., somewhere in West L.A.

Q And you told Mr. Ogg that Mr. Wieland or someone with a name like Wieland was a former employee of Equity Funding?

A I told him who?

Q Did you identify this person as a former employee of Equity Funding?

A You mean the one with the Y tape?

Q Yes.
A Yes.

Q Did you give Mr. Ogg any explanation of how you understood the reinsurance would work, beyond the fact that they were relating to fake policy reinsuring, do you explain how the Ponzi scheme, I think was the phrase in your notes with Mr. Armstrong, worked?

A I don't think I went into any special detail [R. 7650] about that.

The main point I was trying to make to Mr. Ogg was about the indication that there was some falsification with respect to mutual funds involved.

In other words, that would be his main interest.

Ours was incidental with the insurance.

Q What did you tell him, as best you recall, about the allegations you had received regarding faking of records on the mutual funds side?

A Well, that we had the word that there were fake confirmations of mutual fund sales or fake mutual funds.

I was not exactly sure what it was, but it was some kind of phony transactions going on involving mutual funds.

Q What did you tell him about the source of these allegations, beyond identifying that there was some informer who had gone to the New York Insurance Department or the Insurance Department of New York and the Insurance Department of California?

A I couldn't tell him a whole lot.

I just told him I understood it was an employee from the company back in New Jersey and that—I notice in my notes it didn't mention anywhere, but I am positive that I mentioned the name, but I told him I wasn't sure, but [R. 7651] it was a name like "Secret."

Something like that. I wasn't sure of the name.

I wasn't real sure of the fellow's job, what kind of position he held except he was some kind of an executive with this company.

Q Your memory is clear that you told Mr. Ogg that the informer was an executive with the New Jersey Life Insurance Company or a former executive?

A Yes.

That's the way I thought of it and that's the way I told him about it.

Q Is your memory also clear that you also told Mr. Ogg that the name was something like "Secret"?

A Yeah.

Because I never really did get a good fix on it. Otherwise, I would have written it in my notes, but I just carried in my mind it was something like "Secret."

Q Did you tell Mr. Ogg anything more about the faked mutual fund records than you have already mentioned?

A No.

I don't think so.

Q What was your purpose in going to Mr. Ogg to give him this report?

A I wanted to get the assistance of the—

[R. 7652] Oh, I know another thing I told him. It wasn't about mutual funds.

Anyway, I wanted to get their assistance at their end, the SEC's end, in checking, checking out whether there were faked mutual funds or whether there were fake confirmations or whatever was going on about mutual funds because I foresaw that we might have troubles if we went into the insurance company—where our jurisdiction goes, we wouldn't have any trouble going into the life insurance company and looking at their records, but I figured as soon as we tried to get outside the insurance company to trace transactions, particularly with respect to mutual funds, that we would encounter a lot of trouble and problems and I wanted the SEC to go in from their side, the mutual fund side, whoever they had to go through, managers or the fund itself or whoever kept the records to determine what could be determined at their side while we could check from our side in the insurance business.

So I was asking for them to undertake to do that, work with us until we could start an exam immediately.

We wanted them to work with us and that was the main idea.

Q You told them that the California Department [R. 7653] was going to be starting an examination immediately?

A Yes.

Q You mentioned, before your last answer, that you remembered something else you had told him.

What was that?

A Oh, about the fact that we wanted to establish this, you know, this as expeditiously as we could without a lot of difficulty going from one corporation to another and beyond our jurisdiction possibly because we would probably have to act on this merger when it was filed and it hadn't been filed yet, but even—but we would have to have the case pretty well documented and put together inside of 60 days.

Otherwise the law says the transaction is automatically approved unless you disapprove it within that time.

In order to disapprove it, we would have to have it pretty well locked up.

Q When you had finished telling Mr. Ogg about the allegations of phony insurance and reinsurance and false records of the mutual fund share stock side, falsification of bank certificates, did he say anything to you to indicate that he had any familiarity with any of those kinds of allegations?

A Yes.

[R. 7654] He said they had had some kind of previous reports about irregularities at Equity Funding or reports like that, to that effect.

I was kind of surprised.

Anyway, that is what he said.

Q What did he say, if anything, about what had developed from those previous reports?

A I don't know as he characterized what had developed.

He just said they had those kinds of reports before, had checked them out, is all he said.

Q Did he make any other comment about those alelgations of fraud?

A You mean the ones that they had?

Q No.

The ones you reported.

A The ones I am talking about?

Q I am saying if he heard that kind of thing before, if that is a fair summary of what he said then.

A No.

Q Did he say anything else?

A No.

We did a lot of talking, but I don't think of any special response, particularly with respect to fraud [R 7655] in any way.

Q In connection with your statement to him that the Insurance Department had begun an immediate examination and that you hoped to get the SEC's cooperation in examining from their viewpoint, what did he tell you?

A Well, the end result of what he told me was they could not get on it for a couple of months.

This was in March.

I think something like July 1st or some date months away.

Q Did he indicate a willingness to cooperate with you?

A I don't know if it was a willingness.

He was interested.

He expressed an interest in it, but I don't know if I would call it a willingness to cooperate really because I was kind of surprised when he came out with the length of time that it was going to take.

I don't think I considered that as a willingness.

Q To the best of your recollection, how long did he estimate it would be before the SEC would be able to enter into any active work on these allegations?

A At least two months, maybe three.

Q Did he give you any reason as to why they [R. 7656] couldn't get other—couldn't get to it before then?

A I don't recall any language, but I believe it was because they had other things, other work.

By "they" I don't really know who "they" would be.

I know or I observed that Mr. Ogg and his people that came in to go with him—I had been down I think a week before observing some of the arguments in the commodity cases, so I knew they were all busy, so maybe I just understood that they were pressed.

I am not really sure what he said as to the reason why.

Some way I understood it was because they were busy.

Q Did he indicate to you that he or anyone else at the SEC would take action on their own on the basis of your report?

A No.

Q I mean any action until 60 to 90 days later?

A No.

* * *

[R. 7710] Stopping there for a moment, as of the time you went to see Mr. Ogg on the 9th, were you not aware that the Insurance Department of California had already been in communication with the Insurance Department of Illinois to begin an immediate convention examination?

A Yes.

Q Did you tell Mr. Ogg, when you saw him on the 9th, that this California department was going to proceed then and there as soon as possible with an audit examination?

A Yes. We were going to start.

* * *

[R. 7717] Q Mr. Germann, when the Secrist allegations were first reported to you, what was your reaction?

A You know, that it was startling and important.

Q Did you take the allegations seriously?

A Yes.

Q Did you formulate at least a tentative hypothesis of whether or not they might be true?

A What do you mean by that?

Q Did you have an impression as to the credibility of the allegations?

A Yeah. I figured, you know, it could be. Everybody was so excited about it.

Q Who is "everybody"?

A O'Regan and Armstrong and evidently New York.

[R. 7718] Q You say "evidently New York," you never spoke to them, did you?

A No. That is why I say "evidently".

Q Did O'Regan and/or Armstrong say anything to you which led you to conclude that New York was excited?

A Well, the fact that they had telephoned us and the fact that our people had gotten in touch with Illinois to get started on an exam, the whole atmosphere was, you know, they were exicted and they recognized that, you know, this could very well be true.

* * *

EXCERPTS OF TESTIMONY OF MORTON FIELD

[R. 7751] Q Mr. Field, would you state your full name and address for the record, please.

A Morton R. Field, 1901 Avenue of the Stars, Suite 1500, Los Angeles, California.

Q What is your profession?

A I am an attorney.

Q What is the name of your law firm?

A The name of the firm is Goodstein, Coaks & Field.

Q Would you please at this point trace your career for us since the time you got out of law school?

A Well, I got out of law school in 1948 and I joined the staff of the SEC at that time in Chicago and I remained in the Chicago regional office and some of its branch territories until 1950, at which time I was transferred by the Commission out here to the West Coast into the Los Angeles branch office.

I remained with the Commission here until 1952, [R. 7752] at which time they were having a reduction in force and the gentleman who came out with me from the General Counsel's office who transferred out with me, was removed and I was thought to be next, so I at that time elected to resign and I went out into the practice of law. I practiced for myself up until around 1955.

I had a partnership with another friend of mine, Raymond Wallenstein. The firm was known as Wallenstein and Field and we practiced together until I joined my present firm on May 1, 1973.

Q Does your practice, your private practice of law, involve the Securities [*sic*] area?

A I would say my practice of law since about the middle of the 1950's has been exclusively in the securities field.

Q Do you have any particular feelings or did you have any particular feelings in the 1950's and the 1960's as to your duties as a private practitioner to report instances of miscon-

duct or potential misconduct to the Securities and Exchange Commission when they came to your attention?

A I did.

Q Would you describe for us why you had such view or such feeling?

A The feelings, when I arrived out here to California [R. 7753] when I was with the Commission, this area, Southern California, was just like what you saw in the old western movies, a wild barron [*sic*] area here. It was a very unsophisticated area. You had a condition of people who committed fraud in other parts of the country, they found a haven here in Southern California.

So, in practice, in the securities practice, you had to be very careful with whom you were dealing, because you could never get too much of a line on the background of individuals, especially if they came from another part of the country and in order to try to build the credibility of the area somewhat, if anybody came in that indicated or at least appeared to me they may be perpetuating a fraud or may be involved in any kind of illegal activities, I did have occasion at every instance to call the local office of the SEC and advise them of that and sometimes I used to call the California Corporation Commissioner's office as well.

Q Were you acquainted during the 1950's and the 1960's with the staff personnel here in the Los Angeles offices of the Securities and Exchange Commission?

A Yes, I was.

Q Turning to the 1960's, who did you know in the office here in Los Angeles?

A Well, I knew Frank Kennemer; I knew Charly Burr; [R. 7754] Rudy Reinchild was a good friend of mine, Charly Margrin.

I am trying to think of somebody else. I knew a Art Bergman of San Francisco; Art Pennekamp was a good friend of mine, because he was the regional administrator up North.

But locally here those were the individuals that I knew and had contact with in the local office.

Q What was Reinchild's position here in Los Angeles back in the days when you were with the office?

A In those days Rudy Reinchild had the title of being the head of the broker-dealer section for the branch office here and then he later became the assistant regional administrator. I remember that.

* * *

[R. 7767] Q * * * What was the next contact or incident that you had involving the Equity Funding people?

A Well, our offices at that time were located at 6505 Wilshire Boulevard and right next door to our offices was a building owned by Mr. Herbert Glaser, the same Herbert Glaser I testified to earlier.

In that building was his law firm, Glaser and Glaser, and in that locale we all ate in one, the only restaurant around at that time there. I think it is Niblers, right on the corner of San Vicente and Wilshire Boulevard. It's a coffee shop with tables close together and had [*sic*] occasion to be going in there for lunch and the group that would come from Glaser and Glaser's office would come down and sit down in the coffee shop there. They would start talking and start talking very loud and what they would be talking about automatically made people, say, at my table immediately become quiet and start listening, because the conversation would go along, "Well, the stock is down now. We've got a registration statement due to come out next week, but Stanley says the price will be up there. He'll see to it that the price will be up this week and bring the offering next week."

[R. 7768] Language like this and conversation like this would go out and loud enough for people around to hear it and, of course, anybody sitting with me, knowing that I was always interested in the securities business, would immediately look at me and smile and stop and I, obviously, would be listening to the conversation.

Those conversations I used to also report back to the staff down here in Los Angeles.

Q When you are saying "staff," are you referring specifically to the SEC?

A I would always call Rudy. I would call Rudy on it, right.

Q Did these conversations occur more than once during the late 1960's?

A Oh, yes.

As I say, anytime you were there, it just seemed that the conversation, you can just hear it and it was being about Equity Funding there [*sic*].

Q All right.

A The next I remember in the '60's, this would have been more towards the late 1960's, I was having lunch on Hacienda Boulevard with some business people and during the course of the lunch one man there, they were commenting about "head hunters," each particular businessman was talking about the different agency or the different "head [R. 7769] hunter" he uses in acquiring personnel and one of the gentlemen at the lunch made the statement that his "head hunter" told him, "Beware, don't hire anybody from Equity Funding, beware."

Of course, that put my ears up, because Equity Funding is something that I had heard about and come in contact with and it was after that particular meeting, and I did call that into Rudy Reinchild, that I did give—

Q Excuse me, let me interrupt for a second.

A Sure.

Q You say that you called Mr. Reinchild and told him about this comment?

A I told him about the comment, right.

Q At the time did you have any great recollection of what that comment was that you testified to today?

Do you know any of the details?

A No details, because the man is repeating what his "head hunter" told him about warning him not to hire anybody

from Equity Funding, be careful of anybody from Equity Funding or words to that effect.

It was a warning type of a statement.

Q And you called Mr. Reinchild and told him what you had heard?

A Yes.

[R. 7770] Q What was the next thing that happened?

A Well, I myself had alerted everyone of my corporate clients, do not hire anybody from Equity Funding without checking with me.

I did advise every broker-dealer that was represented by our office and by me at the time there that they should not solicit anybody to buy or sell Equity Funding stock and the only transactions to have in the stock would be unsolicited agency transactions.

As a result of what I told my clients, one client represented a man by the name of Mr. Mercado or words to that effect, as a possible candidate for a job in the accounting department of the company, but in view of the fact he was with Equity Funding at the time and in view of my order not to hire anybody from Equity Funding without clearing with me, they sent him over to my office to be interviewed and this was late 1971.

This gentleman had a position in the accounting department of Equity Funding. I think he was still employed at the time.

I asked him why he was leaving or about to leave Equity Funding and he told me that he was scared and I said, "Would you elaborate on that", and he did tell me that Equity Funding at that time was negotiating to acquire a life insurance company in New Jersey and he said that if [R. 7771] that acquisition fell through that Equity Funding would fold and he was scared.

I said, "Well, if it fell, why would you be scared?"

He started to tell me that the company has been in dire straits for cash for years and that they had been using various acquisitions as a means of draining off cash from acquired companies for purposes of covering up their cash position.

So, I asked him about their financial statements and he told me that the financial statements, he said, were wrong. He said

that the financial statements, Mr. Goldblum would always require, as he would say, a certain earnings figure and then they would be inputing or putting through the computers certain numbers which would work out to the sales figures that the company wanted.

I asked a little further how that would be able to go with the auditors in verifying different things and he related to me how, for example, they would show sales of insurance policies by just having confirmations go out to various employees within the company and having the employees affirm back to the auditor that they do own these insurance policies.

I asked him why at this point in time did he feel that the acquisition in New Jersey of this life insurance [R. 7772] company may fall through.

He told me that he was afraid that the people who were negotiating on behalf of the insurance company in New York would find out exactly how poor or what's wrong with Equity Funding right then and there, that it is not as represented to them and they would back away from the deal. He felt it was very eminent for them to uncover the true status of Equity Funding.

We finished the conversation. It was quite an earth shaking conversation, to say the least, and I advised him that he should seek his own counsel. I advised him to go to the SEC and tell them everything he told them and following that conversation, I believe it was probably the following morning, because I remember it was late in the day when I spoke with him, I called Rudy Reinchild and I related the conversation to Rudy.

Q Now, I would just like to go over that conversation in a little more detail with you.

A Go ahead.

Q You are clear in your mind that Mr. Mercado told you that after Stanley Goldblum would set a certain earnings level, they would put the figures in the computer to come up with those earnings; is that correct?

A Yes.

Q You are clear in your mind that Mr. Mercado told [R. 7773] you that he was himself somehow involved in the accounting end of the business?

A He was concerned because he knew what was going on and he was in the accounting department.

Q You are clear in your mind that Mr. Mercado told you specifically that they would have these phoney policies and send out phoney confirmations; is that correct?

A That's correct.

Q And he told you this all in specific context with the then proposed Bankers National Life acquisition; is that correct?

A That's correct.

Q Can you remember anything else by way of details that Mr. Mercado told you in the conversation you had with him in your office that day?

A No. Unfortunately I didn't make any memorandum of it.

He was just being interviewed for a possible job with a client, which job he did not get.

JUDGE: What date was this?

THE WITNESS: This was late in 1971.

BY MR. BONDERMAN: Q You said the next morning you called up Rudy Reinchild and told him about this conversation?

A Right.

[R. 7774] Q Did you give him all the details you had at the time?

A I gave him everything I had at the time, right. Everything was fresh in my mind. I let it out on Rudy, let him have it.

* * *

Q Did you hear from anyone at the Commission after your conversation with Mr. Reinchild?

A Yes. Marty Robins called me on the telephone and he went over the facts as given to him by Rudy Reinchild as Rudy

got it from me and Marty did ask me if I knew of anybody who might be able to give him some testimony that worked for Equity Funding and I gave him the name of Mercado and I gave him the name of John Templeton, who was working for a client of ours.

Q I just want to be very clear.

Again, when you spoke to Mr. Robins, you told him specifically about phoney policies?

A Yes.

Q You told him specifically about phoney confirmations being sent to employees?

[R. 7775] A Right.

Q You told him specifically about the cash problems that the company had?

A Right.

Q You told him specifically about Mercado's fear with respect to the company folding if they did not acquire Bankers National?

A Right.

Q So you gave him and you discussed with him every detail you had gotten from Mr. Mercado?

A That's correct.

Q Do you recall approximately when that conversation was?

A Oh, I would say that the first conversation might have come, the first conversation with Marty, I spoke to Rudy Reinchild the following morning after I had met with Mercado, I would say that Marty called me within the week. I would say within a week's time, the first time.

Q Did you have a subsequent conversation with him?

A I had a second conversation with Marty Robins. It might have occurred several weeks thereafter. It might have been as long as a month, not longer than a month.

He did tell me that he struck out in trying to talk with Mercado and with Templeton and he asked me if I knew anybody else who might be able to give some information [R. 7776] or throw some information on the matter.

I told him I didn't know of anybody else.

* * *

Q When Mr. Robins told you he had struck out with Templeton and Mercado, did you understand what he meant?

A Yes. He said they would not talk to him.

* * *

EXCERPTS OF TESTIMONY OF WILLIAM MERCADO

[R. 8399] Q Was this December of 1971?

A That's correct. I was leaving Equity Funding and I was called in by Stanley Goldblum—no, as a matter of fact, it couldn't have been December—yes, it was either the latter part of December or the beginning of January, that's when it was and we were pretty much saying our good-bys [*sic*]. He wished me good fortune and just as I was ready to leave the office, he stopped me and he said to me, "It's very likely that the Securities & Exchange Commission will be calling you and that they would probably want to discuss things about the company.

They are prying into our business. I believe that there are several companies that are involved, companies and people, that are involved in circulating disparaging remarks about our firm and it could possibly be some kind of a play on the stock.

I would appreciate it if you used discretion and not discuss any of the affairs of this company with the SEC as, frankly, I feel that they have been poking their nose, so to speak, into our business more than they should."

[R. 8400] Q Did you have any comment that you made to him at that point?

A Yes. The comment I made to him at that point was, "Are you asking me to withhold information or to lie?"

He said, "No. I am simply asking you to use discretion in what you discuss with anybody, because the information that you have been exposed to or that you may know is company confidential and should not be discussed with anybody."

Q After Mr. Goldblum told you to expect a call from the Securities & Exchange Commission, did you get such a call?

A Yes, the next day. I got a call at about 10:00 o'clock in the morning from a gentleman by the name of Marty Robins.

Q What did Mr. Robins say to you in that conversation?

A That it was important that I meet with the SEC; that they were conducting an investigation into the affairs of Equity Funding and, as such, they had spoken to several ex-

employees and being that I had left the company, they would like to see me about it and a meeting was set up for the afternoon at 2:00 o'clock.

Q Did you go to that meeting?
A Yes, I did.

[R. 8401] Q Who was there?
A Marty Robins and his assistant, whose name I do not remember at this time.

Q And you were there.
Were you represented by counsel at that time?
A Well, what happened was the meeting time was set rather suddenly and I was attempting to reach my attorney named James Jess, who was unfortunately unavailable.
I believe he was at a trial and out of town.
JUDGE: For clarification, was Attorney James Jess the one you had talked to earlier?
THE WITNESS: Yes, sir.
JUDGE: And related your information?
THE WITNESS: Yes, sir.
JUDGE: Thank you.
THE WITNESS: So, in attempting—I was unsuccessful in attempting to reach him. So, I left a message with my wife to the effect that I was on my way to the SEC and that she should try and reach Jim, who was due back in his office, supposedly, sometime around 1:00 or 2:00 o'clock and that [*sic*] was going to the SEC to meet with a Marty Robins and if he would please join me there.
Subsequent to that, I left and I went for a meeting with the SEC.

[R. 8402] Q Did Mr. Jess join you there?
A No, he did not.

Q Did you later find out why he didn't join you?
A Yes.
After the meeting with the SEC, when I spoke with my attorney, he was furious at the fact that I had gone to the SEC without the benefit of counsel and, furthermore, he told me,

"Where were you?" And I told him I was at the SEC in some office and he said, "Well, I went there looking for you and I was told that they never heard of you and, furthermore, that there was no meeting going on as far as they were concerned."

BY MR. BONDERMAN:

Q Now turning back to the meeting which was going on at the time, how long did your meeting with Mr. Robins and his associates last?

A I really don't remember exactly, but it must have taken somewhere around two, two and a half hours, maybe more. I'm not sure.

Q During the course of that meeting, Mr. Mercado, did you tell Mr. Robins, as you had previously told Mr. Field, that you knew about this accounting plug?

A No, I did not.

Q Did you tell Mr. Robins, as you had previously told Mr. Field, that you had heard rumors to the effect of [R. 8403] fictitious insurance?

A No, I did not.

Q Why didn't you tell Mr. Robins that?

A Basically, after I had had that great meeting with Stanley Goldblum in which he told me that the SEC was going to be calling me next day, or when he told me the SEC was going to be calling me and the next day I got a call from Marty Robins, I felt I was being set up.

So, my policy there was to be as discreet and as cautious as possible and disclose as little information as possible, especially being that I was not represented by counsel.

Q In the course of that meeting, did Mr. Robins ask you point blank whether you had heard of fictitious insurance?

A I do not remember, but I don't believe so.

Q In the course of that meeting, did Mr. Robins ask you point blank whether you knew about falsification of earnings?

A If I might make a statement to clarify your line of questioning, counsel?

Q Certainly.

A The meeting, shall we say the basic spirit of the meeting was completely informal, and I was told that at the very beginning of the meeting that this was a [R. 8404] totally informal [*sic*], looking into the affairs of Equity Funding and that it was being done very discreetly and that it was being done on a totally informal basis as extreme caution had to be used in order not to precipitate some kind of problem for the company that could injure innocent stockholders.

So, there was no hard grilling or questioning in that sense. It was primarily questions of a general nature.

Q All right.

So, I take it that your answer is that he did not ask you point blank if you knew about inflation or the falsification of records?

A No, not that I can remember at this time.

Q Did you come to a second meeting with Mr. Robins with your counsel present?

A Yes.

After I had the meeting with Mr. Robins, I went to my attorney and I spoke to him about it and told him all the details about the meeting and he asked me specifically what I had said and I told him what I had said and he said, "Well, I'm glad at least you used some common sense in keeping your mouth shut."

He said, "The best thing for us to do now is to immediately contact the SEC again and have another [R. 8405] meeting with them right away, at which we will present to them that you have information material to the investigation of Equity Funding, but that you are not willing to disclose any of that information unless immunity is granted to you first."

Q Did you have such a meeting?

A Yes.

Q Who was present at that meeting?

A My attorney, Mr. Robins and his assistant, who I don't remember.

Q Do you remember what Mr. Jess said to Mr. Robins in the course of that meeting?

A Yes.

What he said to Mr. Robins was that Mr. Mercado had information that would be important and material to their investigation of the Equity Funding case, but that he had instructed his client not to say anything unless immunity was first granted.

Q Do you recall what Mr. Robins' response was?

A Yes. That the SEC was not in the business of giving immunity and that they could not even discuss it.

Furthermore, that if there was an issue of immunity involved, that we should contact the United States Attorney and discuss it with him.

Q Did he tell you anything about his continuing [R. 8406] interest in investigating Equity Funding?

A This is where my memory fails me a little bit, counsel.

That statement to the effect that the Equity Funding investigation was closed, the case was closed and there was no longer a need for any information, came in either at that meeting or at a subsequent meeting and I don't really recall, but that statement was made.

I believe it was on the second meeting, where Mr. Robins told my attorney that it was really not that important anyway and that—

Now I remember—wait a minute—I think there were a total of possibly three meetings.

There were two meetings one right after the other after I met with Mr. Robins. Then there was a meeting with my attorney and then there was a meeting which took place several months later possibly.

Q So you think that you had three meetings with Mr. Robins?

A Yes, possibly.

I wasn't involved in the first one, I don't think.

Q You think that your attorney met with him alone?

A Yes, right.

Q Let me just make it clear that it is your [R. 8407] understanding that a comment was made either in a second or a third meeting by Mr. Robins that there was no need for your information—

A It would have to be the second meeting, because I was there.

Q A comment was made at a meeting at which you were present by Mr. Robins that there was no need for your information because the investigation was not being pursued; is that correct?

A That's correct.

* * *

[R. 8451] Q Is it fair to say, Mr. Mercado, that the substantive matters about Equity Funding, which we have discussed at the Robins' meeting, were 180 degrees different from what you had discussed with Mr. Field a [R. 8452] month before?

THE WITNESS: I think it's fair to say that I did not volunteer any information or come out with any statements regarding what was going on at that time, because what had been presented to me as a very informal hearing, all of a sudden started to look very menacing and I knew that I was treading on thin ice.

* * *

EXCERPTS OF TESTIMONY OF STANLEY GOLDBLUM

[R. 8524] Q * * * What was your perception of Mr. Dirks at that time as to whether or not he was convinced of the truthfulness or accuracy of the information that was derogatory about Equity Funding?

A I had the impression that he was very much convinced that the information he had was correct.

* * *

[R. 8548] Q You were asked a question concerning the calls you were getting from brokers and you said towards the end you were getting as many as ten calls a day from brokers.

Were those calls relating to the volume and price action in the stock?

A Yes.

Q Were those calls relating to details and specifics of the story that Mr. Dirks had related to you or that you knew about?

[R. 8549] A No.

Many people called who asked me what was happening. They had not heard the rumors but wanted to know what, if anything, was the reason for the price action and the volume.

* * *

[R. 8571] Q In your cross-examination, Mr. Goldbloom [*sic*], at one point you made a point to the effect that had Mr. Dirks been wide of the mark with the elements of investigation "We wouldn't be here today." Explain what you meant by that, please.

A If he would have been wrong, there would have been no fraudulent reinsurance, et cetera, and there would have been no following events that took place since then. That's what I had in mind.

Q Do you hold Mr. Dirks personally responsible for [R. 8572] having uncovered the events at Equity Funding which you were denying during those weeks?

A I think Mr. Dirks is entitled to personal credit for that.

* * *

[R. 8574] Q The entire period preceding March, 1973 during which fictitious insurance had been on the books of EFLIC, were you ever approached in any serious manner by any auditor of the parent or subsidiary with information which would have led to the uncovery of the fraud?

A I don't know what you mean by any serious way.

Q Did any auditor for the parent or subsidiary ask you any questions which suggested to you that they suspected there was a fraud at Equity Funding?

[R. 8575] A No.

Q Did any person from any Federal regulatory body as [*sic*] you any questions which led you to believe that they were suspicious of fraud at Equity Funding?

MR. MALAWSKY: Could you put a time on that?

BY MR. BONDERMAN:

Q Prior to March, 1973, I am sorry.

A No.

Q Prior to March, 1973 did any employee or agent of any State regulatory body ask you any questions which would lead you to believe that they suspected there was fraud at Equity Funding?

A No.

Q Is it your belief, Mr. Goldbloom [*sic*], that in the absence of Mr. Dirks spreading these rumors in March of 1973 the fraud would have gone uncovered?

A Ask me that again.

Is it your belief that had these rumors or the allegations not come to Mr. Dirks' attention in March of 1973 that the fraud would have gone uncovered at Equity Funding Corporation of America?

A It's a very hard question to answer. I can conceive of a set of circumstances where the answer is yes.

Q What are those circumstances?

A Where the people who brought the information to Mr. [R. 8576] Dirks in fact themselves discontinued doing so and

were [*sic*] the then employees of the company continued to perform the functions they were performing in the way they were performing them and that no other investigative body would attempt to uncover the false information. I guess under those circumstances it would have continued for a while.

Q In fact, wasn't it your belief in 1973 that if you had another year or two you would get all this phoney insurance off the books?

A Yes.

Q In which case as far as you were concerned this fraud might not have been discovered; is that correct?

A It was my belief that given a period of time in the order of two years or so that we would have corrected the problems in such a way that the fraud would not have been discovered.

Q Do you hold any animosity or bitterness against Mr. Dirks for the fact that he precipitated the events which led to the discovery of the fraud?

A Not now.

Q Do you remember Mr. Simonds making a comment to you this morning before this proceeding commenced that Mr. Dirks was really swimming against the tide at that point?

A I heard him say that.

Q What did you say in response?

[R. 8577] A I hoped he drowned.

* * *

EXCERPTS OF TESTIMONY OF WILLIAM BLUNDELL

[R. 8679] Q Did there come a time sometime in March of 1973 when you heard there were rumors floating around about Equity Funding Corporation of America?

A Yes.

Q How did you first find out about those rumors?

A I first found out about them from an opposite number.

Herb Lawson called me and said he had been contacted by Dirks and Dirks had told him about certain things that purportedly were happening at Equity Funding Corporation.

And he told me that Dirks was going to be in Los Angeles the next day or arriving that night.

"I want you to get in touch with him."

Q Did Mr. Lawson tell you the nature of the allegations?

A In a very general way.

Something about phony insurance, this sort of thing.

[R. 8680] I don't remember the specific allegation.

Q Can you remember the type of detail he provided?

Specifically, did he tell you that there were allegations of phony policies on the books?

A Yes.

Q Did he tell you that there were allegations of reinsurance of these phony policies?

A I don't recall.

I don't believe so.

Q Do you recall if he told you there were allegations of other kinds of fake assets or nonexistent assets?

A In a general way, he may have.

Q Do you recall whether he told you that there were allegations that the officers of the company were about to flee the country?

A I don't remember that.

Q With substantial assets?

A I don't remember.

Q Do you remember anything else that he told you?
A No.
It was a very brief conversation.

Q What was your reaction when you were informed of these allegations in a general way by Mr. Lawson?
A It was just another rumor and we get rumors all [R. 8681] the time.
Some we can get checked out if they are promising.
Others where we can't get a handle where the information is so vague and so general or the source won't talk to us personally, we usually forget it.

Q When you say you get rumors all the time, do you get rumors of fraud at substantial companies on a frequent basis?
A Well, I couldn't say rumors of fraud in substantial companies on a frequent basis, but we do get allegations of fraud and all sorts of companies, most of them anonymous, most of them with information that is simply unavailable.
They will say "look into so and so," as if we could march in there and throw the chief executive against the wall and ring the truth out of him.
Most of them have to be left out because they are a waste of time to pursue.

Q After you got the call from Mr. Lawson, what did you decide to do with respect to the rumors he told you about?
A I decided to talk to Dirks and called him at the hotel and made an appointment to meet him.

Q Did you have any conversation with Mr. Dirks at that time beyond setting up the appointment?
[R. 8682] A Not that I recall, not anything significant.

Q Did you meet with Mr. Dirks?
A Yes.

Q Do you recall when that was?
A It was the day following, I believe, at around 3:30 at the Beverly Wilshire Hotel.

Q Can you recall what day that was?
A The 21st.

Q Of March?
A Yes.
It would be somewhere around the middle of March—in March.

Q Let me state that there is a calendar for you to look at.
There is testimony in the record from Mr. Dirks that his meeting with you was on the 21st and I take it that is consistent with your recollection.
A That is consistent with my recollection.

Q Do you recall how long the meeting with Mr. Dirks took?
A Two and a half hours, somewhere in there.

Q Do you remember precisely where the meeting took place?
A It took place in the Hideaway Bar, a cozy, little nook in the Beverly Wilshire.

[R. 8683] Q Can you remember what was said during the course of the meeting?
A A great many things were said.
Ray outlined for me the allegations that he had heard supposedly from people who used to work for Equity Funding and some were still employed by Equity Funding. They had to do with the manufacture of phony policies which were supposedly resold to gullible reinsurance companies at a very large profit to Equity Funding.
We talked about the forgery of the policy files, if I recall.
I can't remember if we got into the death claims issue or not.
We talked about the possibility that their earnings might have been skewed and the earnings of the insurance company particularly being pulled out of thin air.

Q You mean EFLIC?
A Yes. The main subsidiary.

Q Did Mr. Dirks have any notes with him?

A I have never seen Mr. Dirks without notes. Mr. Dirks had a full briefcase all the time.

A large part of our conversation had to do with educating me somewhat in reinsurance and why they did it and so forth.

[R. 8684] Q During the course of this conversation, was it your impression that Mr. Dirks was going through his notes and repeating to you information which was contained in those notes?

A At times.

I think most of the papers were such a jumble that I couldn't say that with a certainty. It was not a question of his saying, "And then so-and-so told me" and consulting his notes.

That may have happened a couple of times, but mainly it was a general, face-to-face conversation.

Q Do you recall that he specifically told you about the allegations of phony insurance policies?

A Yes.

Q Do you recall he specifically told you that there were allegations that there were phony policies being reinsured?

A Yes.

Q You cannot recall whether he told you at that time or at a later time about phony claims or death benefits?

A He may have.

That would be consistent with my recollection.

Q What about allegations of missing assets?

A I don't remember any allegations of missing [R.8685] assets.

I do recall general conversation on how the books might have been skewed.

You say "missing assets."

I think it was more a case of overstating assets that they did have and understating their liabilities.

Q Did Mr. Dirks give you the names of persons who had furnished him information?

A He gave me the names of probably everyone who worked for the company at any time and he mentioned several people and recommended that I talk to them, which I did.

Q Did he give you the name of Ron Secrist?
A No, because I had gotten that from Herb Lawson before.

Q You already had that name before you met Mr. Dirks?
A Yes.

Q Did he give you the name of Mr. Frank Majeurus?
A I would rather not go into the names that he gave me. I can tell you that I talked to a number of people that he recommended I talk to, and I talked to other people as well.

Q Well, let me state, Mr. Blundell, I appreciate [R.8686] your interest in protecting your sources.
On the other hand, Mr. Dirks is my client and I don't believe that what he told you is protective in any way.
I don't intend to ask you any questions as to who you talked to based on the information.
A I can tell you that on that list which included then practically everybody in the official persons who worked for the company that Frank Majeurus' name did appear.

Q Did he indicate specifically which of these people on the list had given him information?
A He didn't give a full recounting of who he had gotten the information from, but he mentioned several names in the course of things.
"So and so said this. He told me that," and so forth.

Q Did he tell you in the course of this information that he thought you ought to talk to certain particular people as opposed to the entire list?
A Yes, indeed, he did.

Q Was there any conversation in the course of this meeting between you and Mr. Dirks as to the possibility of or credibility of the likelihood of these rumors being true?

[R. 8687] A There was a great deal of that discussion because both of us had certain problems with the information and one of the principal problems was the difficulty of the auditors.

There had been at various times—this was a fraud that was supposed to have involved both the parent company and the largest insurance subsidiary. Various times there had been three auditing concerns—two of them had been Big 8's—that worked on the insurance company and I guess the parent was always Seidman & Seidman, but the insurance company where the fraud supposedly centered in the manufacture of policies had been handled by Haskins & Sells as well as Seidman & Seidman and I think before that by somebody else, and the stuff had never been detected.

If it existed in the scale which supposedly it existed in, neither one of us could see how any auditor worth a dam could have missed it.

That was the unsurmountable problem we had.

Q Basically because of the fact that the auditors had given clean reports you had difficulty comprehending that this could possibly be true; is that correct?

A Not because basically the auditors didn't give a clean report, but because of the reported scope of the fraud I did not see how it could have been missed by an [R.8688] honest auditor and we made the assumption that the auditors were honest.

Q From that you didn't see how it could be true; is that correct?

A That's correct.

Q Was there anything else in the nature of the purported scheme that caused you to question the believability or likelihood?

A Yes.

There was a problem with the reinsurance, how the reinsurers could miss all of these policies that were being sold to them as being bogus and how the company which had a liability for

the payments of premium in the years after the initial sale of the policy and the premium—90 percent of it would go to the reinsurer—we could not understand if there was this much phony business on the books, how Equity Funding could possibly keep up with the cash needs that would have to flow to the reinsurers.

Of course, they were keeping up in a geometric way.

The thing was an inverted pyramid.

The more phony business you sold to others, the greater your liability the next year, meaning you would have to sell twice as much phony business.

[R. 8689] We saw that this could happen, that the sales could happen, but we didn't see that it made any sense for the company.

The company was digging itself in a hole that they could never get out of.

Q That also led you to conclude it was not likely to be true.

Is that also correct?

A Yes.

Q I take it that at the culmination of this meeting with Mr. Dirks it was your impression that the story was not likely to be true; is that correct?

A Yes.

It was my impression that the story in its full scope was not likely to be true.

Q Did Mr. Dirks in the course of the conversation tell you that he thought these allegations were likely to be true?

A I think he was undecided.

I can't remember clearly.

He was certainly—he certainly didn't come all the way out to Los Angeles if he felt that the story was completely phony.

On the other hand, he could see the difficulties involved in it, and I think—or the feeling the both of us [R.8690] had was:

"We have all these people telling us it happened, but it doesn't make any sense."

I think the feeling was one of puzzlement rather than complete disbelief.

Q Would it be fair to say that he shared your views as to the auditor problems?

A Yes.

I think that's fair to say.

Q Would it be fair to say that he shared your views as to the practical difficulties that this would cause the company? An inability to see where it could benefit the company?

A I think that is fair, yes.

Q I take it that Mr. Dirks did not say to you at any time during the course of this meeting that he thought this was true?

A I simply can't recall any flat statement of that regard.

Q Did you take any notes during the course of your meeting with Mr. Dirks?

A Very few because Mr. Dirks was not a source for me. He was a tipster and that is different from being a source for any story I might do.

[R.8691] Q Tell us what you mean by "source."

A To me, in a story of this nature a source would be someone who actually did, saw, or heard here the things that would be useful to me in my story.

Ray had nothing to do with the Equity Funding fraud and he never saw anything happen in Equity Funding and everything that he heard was secondhand, and consequently, as far as I am concerned, inadmissible.

Helpful but inadmissible.

Q I take it after speaking to Mr. Dirks you didn't feel that you had any particular evidence of fraud at Equity Funding?

A None whatsoever.

What I had was a security analyst telling me that other people told him that there was fraud at Equity Funding.

Q Let me ask you this:

After you had heard the story, did you have any alternative explanations for how this story might be around besides the fact that it could possibly be true?

A If you want to be super-skeptical about it and we really have to be, there is a possibility of a combine, of people who where short on the stock.

The stock had been very volatile. It had been going down very sharply. That possibility existed.

[R.8692] Another possibility that Dirks or his clients had certain interests in the stock and interests that I would not necessarily know about and that he wouldn't tell me about.

I did not know Dirks.

And the other possibility is that part of the story might have been true.

There's minor hanky-panky here and there. There might be fenceposting of some phony policies, but not that many, but there might be petty embezzlement but not that much, but the story would not nearly be as big a story as we were led to believe.

Q Mr. Dirks told you and I take it Mr. Lawson that these allegations had originally come from Mr. Secrist?

A That's correct.

Q Did you think of any motive of Mr. Secrist to spread allegations like this if they weren't true?

A We frequently get—yes.

The motive might be revenge.

We frequently get complaints and tips from people who have been discharged by these companies for one reason or another:

A grudge against them and they want to make trouble for them. This might have been the case with [R.8693] Secrist.

I did not at first know that he had been discharged by the company. He only said that he left the company and he left me with the impression that he left in some sort of moral outrage.

I did not know that he had been fired or laid off.

Q When you found out he had been fired, did that impression change?

A Yes.

It led me to doubt his motive and along with his motive, credibility.

Q When is the first time you spoke with Mr. Secrist?

A I don't remember.

I think I spoke to Secrist perhaps either right before I spoke to Dirks or right after.

I had two conversations with Secrist, one at the beginning of this investigation job and the other at the end.

Q All right.

Did Mr. Secrist tell you anything in the first conversation that Mr. Dirks did not tell you in your meeting with him?

A Not that I recall.

[R.8694] I simply wanted to hear the general allegations from Secrist himself since he had been an employee of the company.

Q Let me ask you this question again:

Do you recall whether you had heard general allegations from Mr. Dirks before you talked to Mr. Secrist?

A I do not recall because I don't know the time frame as to exactly when I talked to Secrist.

Secrist and Dirks were very close together, but I can't say who came first on the first conversation.

Q Did you have any notions of publishing a story on these allegations after the 21st or publishing at that time?

A Publishing, detailing these allegations?

Q Yes.

A No.

Q Why not?

A First of all, they were flat-out rumors. I had not proved anything.

The information that I had from Dirks was as I pointed out unusable.

If I had gone ahead and given the nature of those allegations without any proof, it could be extremely damaging to the company and its stockholders and bondholders.

[R. 8695] Q And so I take it you are not inclined to do something like that?

A No, I am not.

Q Did Mr. Dirks mention to you in the course of your meeting on the 21st that he had met Mr. Goldblum and other high executives of the company who had denied all these allegations?

A He said he did, yes.

I believe that he did, yes.

Q Did you have any feeling on or about the 21st after you talked to Dirks that either you or he should go to the SEC with the allegations or information?

A I had no feeling that either one of us should go.

I can't answer for Ray. He does what he wants to do.

My own feeling is that I had nothing that would have been of interest to the SEC outside of a rumor.

Q Now, why is that?

Explain your answer in a little more detail.

A We frequently get information from people and the last thing that I would do would be to run to the SEC with just wildhair rumors about things that are supposedly going on without any real lead for them to follow [R. 8696] or any indication on my part that there might be some truth in them.

There was absolutely no support for the allegations. Until there was some support and until I felt convinced that there might indeed be some truth, not the whole story, but something of the truth firsthand, then I wouldn't go to them.

I might not go to them anyway, I ought to add, because we do not work hand in glove with the SEC.

We cooperate with them in certain matters but if I have got a story then, and I can get the whole thing and get it out, I am not going to go to the SEC.

Q With regard to appropriate occasions from time to time you have gone to the SEC as you did in this case ultimately?

A Yes.

Q I take it you have had some experience in working with the SEC even though you didn't feel obligated?

A Yes.

We would commonly work with the SEC on various matters.

Q Mr. Blundell, do you remember being deposed in a deposition at 9:30 a.m. on February 24, 1976?

A Yes.

[R. 8697] Q I'd like to refer you to pages 73 and 74 of that deposition.

The question starts on line 27, page 73, and your answer which runs over through line 16.

Would you read that and let me ask you if that answer is true and correct to the question?

A That's correct.

Q I am going to read the question, and would you read your answer that you gave under oath at that time?

"I now direct your attention solely to the conversation of March 21, 1973. Did you form any conclusion as to whether or not that information should be conveyed to the SEC at that time?"

A "My conclusion, basic conclusion, was that, no, it shouldn't. The SEC has much the same problem that we do in the sense that they get a lot of over-the-transom stuff and they need something to chew on. They need some people to talk to. The more sources they have the better and the more credible sources they have the better. To me, Ray Dirks was no source at all. He was just, you know, a little guy off the street dealing in hearsay [R. 8698] and Secrist I knew nothing about. We knew he had left the company under circumstances that turned out were not the best. Consequently, it might be just another source of a guy—and the SEC gets these all the time—who feels he has been shafted and wants to make trouble."

Q I take it that is consistent with your present view?

A Yes.

Q Now, after you spoke with Mr. Dirks and met with him on the 21st, did you decide to go ahead and investigate the story yourself?

A Yes, I did.

Q And did you do that?
A Yes, I did.

Q How long did your investigation last?
A Probably 10 days.

Q Can you tell us from your recollection, when was the first time that you felt comfortable publishing a story detailing what you thought was going on at Equity Funding?
A Publishing a story that would say unequivocally what I felt was going on at Equity Funding?

Q Yes.
[R.8699] A That would be on Friday evening which would be March 30.

Q When was the first time you felt comfortable publishing any story with respect to rumors or what was alleged to be going on at Equity Funding?
A That is harder to explain because there was news being generated during this period by events that I had nothing to do with.

When an event happens—a press release by a company or something significant—it is taken out of my hands unless I think the matter is so trivial and so self-serving that it is not worth covering.

Once I decide the matter that the company is bringing up is worth covering, then I have to do something about it.

I want to make that distinction.

The main feature story on April 2nd was my own volition when I had decided.

The other coverage arose from things that happened outside of my control, namely, the company making a statement about the rumors, that sort of thing. In that case I definitely would print something, and we did.

Q All right.
We will get back to that in some detail, but let me ask you this:

[R. 8700] Did you speak to anyone in the course of your investigation on the next day, the 22nd?

A I don't remember.

I very well may have.

Q Did you speak to anyone in the course of your investigation on the 23rd?

A I spoke to some people most every day right up until the time we published.

* * *

[R. 8701] Q Did you meet with Mr. Dirks and two other people at one time?

You had a third conversation with Mr. Dirks where he told you about the notes and you had, I believe, a fourth conversation where he asked if you were ready to do anything?

A There might have been more a single inquiry on his part as to whether I was able to to anything.

I remember once or twice. That's the best of my recollection.

There was no information passing between us at that time.

It was just a touching-base sort of thing.

Q With respect to these inquiries from Mr. Dirks as to whether you are ready to do anything, is that to say that Mr. Dirks was asking you to print a story on the [R. 8702] subject?

A I believe my recollection is that was his interest.

He wanted to know if I had enough to print the story.

Q So it was your understanding that Mr. Dirks was interested in having you print the story on this subject?

A That was my understanding.

Q When did you first become convinced that the story was true?

A I became convinced that the story was true after talking to a couple of people—or at least key parts of it were true—after talking to a couple of people at Equity Funding who admitted to me that they had engaged in various criminal action and who emotionally broke down about this thing.

This is very credible type information.

Q Now, do you recall when that was?

Can you give us a time frame of this period that we are talking about?

A That would be early—it would be between the 21st and the 26th.

Q Was it before you called Mr. Sporkin?

A I cannot remember.

[R. 8703] Q Did you at one time decide that that matter should be brought to the attention of the SEC?

A Yes, I did.

Q Do you recall when that was?

A Within a couple of days at—after talking to Mr. Dirks I talked to several people myself and asked them what they had done, seen, and heard; and the answers were sufficiently alarming to me so that I felt the SEC ought to know about what the information was with an eye towards stopping trading in the stock.

Q Do you recall when that was that you reached this conclusion?

A Around the 22nd or the 23rd.

Shortly—very quickly after I talked to the first few people.

Q What did you do after reaching that conclusion?

A I called up Jerry Boltz who was the Regional Director of the SEC.

Jerry was quite ill and I called up Stanley Sporkin who was the head of the Enforcement Division of the SEC.

Q Did Mr. Boltz suggest that you call Mr. Sporkin?

A I do not remember.

Someone else may have.

Q Did you speak to Ralph Erickson when Mr. Boltz [R. 8704] was out?

A I may well have spoken to Ralph, yes.

Q You called Mr. Sporkin in Washington?

A Yes, I did.

Q Do you remember what you told him?

JUDGE: What date was that?

THE WITNESS: I cannot remember the exact date. It probably would be the 23rd.

And I called Mr. Sporkin in Washington and no one has protracted conversations with Mr. Sporkin. If this young lady has trouble with me, she should have Stanley Sporkin on the stand.

Anyway, he very quickly decided to look into it.

I told him I had talked to several people who had told me that earnings were being manufactured at the main insurance subsidiary of Equity Funding, who told me that they had engaged in—I believe we were in the policy file forgery at this time and that a certain amount of business was being resold to reinsurers that did not exist.

BY MR. BONDERMAN: Q At the time you talked to Mr. Sporkin, did you have any idea of the scale of what was going on at Equity Funding?

A I knew what the scale was purported to be just by [R. 8705] rumors.

Once again, no one absolutely knew.

Q Did you have any conviction yourself as to what the size of this fraud was likely to be?

A I had no conviction or knowledge at that time.

I knew it seemed to me significant.

Q You have told us what you told Mr. Sporkin.

What did Mr. Sporkin say to you, if you recall?

A Mr. Sporkin said something to the effect that they were going to get on it right then and sure enough that's what they did.

Q Did you have a phone call from someone at the SEC or did you call them again?

What was your next contact with the SEC?

A The next contact I think was initiated by the SEC and we had a meeting.

Several people from the Los Angeles office of the SEC came to my office.

Q Do you know when that was?
A It was probably the following Monday, which would be the 26th.

Q Do you remember what time of day it was?
A I do not remember.

Q Do you remember who came to your office?
[R. 8706] A Well, I know Les Ogg from the SEC was there. I believe Jerry Boltz was there. I believe Ralph Erickson was there.

Q Do you recall anyone else?
A No, I do not.

Q Do you recall anyone from the Wall Street Journal besides yourself that was there?
A I do not recall.

Q Can you tell us what was said in the course of that meeting?
A In the course of that meeting I told them without disclosing the source of my information that I had talked to people who had told me—led me to believe, anyway, that something really terrible was going on over there, mainly the resale of policies to reinsurers, policies that did not exist, the creation of phantom business, the manufacture of earnings. Those were, I guess, the two principal things.

I cannot remember whether we got into the death claims issue or not.

Q After you had given this information to the people at the meeting, what was the response?
A The response was that we begin mutually to examine this information.

I did not present this information as gospel. I [R. 8707] do recall that it seemed to me that the people who told me were very credible sources and this was the reason I called them and they began to—we began mutually to examine the problems

and the auditors' problem came up, the problem of the terrible geometry of this whole scheme as far as rebounding on the company within a very short period of time, which we couldn't figure out: how anybody in the underwriting or insurance business would try to undertake such a mad scheme that commonsense would tell him would have to collapse around their ears in a very short time. We could not understand. We didn't get over these hurdles.

Q Who was asking questions from the SEC delegation?

A I believe all of them were asking questions or most of them at one time or another.

Q Did Mr. Ogg play a particular role in that meeting?

A Yes.

Les Ogg was along because he supposedly knew a good deal about insurance companies.

At least, this is my recollection of someone, Les, being there; because he knew about insurance companies.

He asked I think the most penetrating questions [R. 8708] having to do with the geometric nature of the fraud and the problems involved, why would anyone do this, and stuff like this.

Q Did you have the impression based upon Mr. Ogg's questioning that he was skeptical of the likelihood of this massive fraud being true?

A I can't get into his head and say that he was or wasn't, but I think he was skeptical.

My impression was that he was skeptical that anything of this scale could have happened.

Q That was for the same reasons that you expressed previously that you were skeptical?

Specifically, you had the auditors' problem; is that correct?

A Yes.

I think he stressed the nature of the reinsurance business and the obligations of the company that sells policies.

My own feeling was the auditors, but together we sort of bumped into these two problems and we were chewing on them

and really came to no resolution as I recall as to how it could have reasonably happened.

Q I take it that at the time you had the meeting with the SEC, though you had talked to a number of people who did not regard yourself in the position of publishing [R. 8709] the story as to what was going on at Equity Funding?

A No, I did not.

* * *

[R. 8738] Q Mr. Blundell, I'd like to ask you a few more questions.

Is it fair to say that when you first heard the allegations from Mr. Dirks in the meeting of the 21st, you thought they were quote "laughable" unquote?

A Yes. When I say "laughable" in a double sense. I thought they were unbelievable and I also thought if there was any germ of truth, it would be the greatest piece of chutzpah in American corporate history.

Q Did you also have a notion when you heard this quote unquote sounded terribly unlikely?

A Yes.

Q Was it also the case that Mr. Dirks agreed with the quote unquote sounded terribly unlikely?

A I think he was—he obviously thought enough of what he was hearing to come out here. He obviously put belief in what some people were telling him but, yes, I do agree that both of us had certain problems in believing that the whole thing could be true.

Q In your view as an experienced journalist, would [R. 8739] any reputable journalist published [*sic*] a story of the sort that you ultimately had published on April 2nd before that date?

A Well, no one that I call responsible based on the information that I had because I was getting—right through Saturday it was really a very short time to develop a story like that—at least for us.

Q With respect to your publishing an article, isn't it fair to say that Mr. Dirks made it clear to you that he wanted to publish the story as quickly as possible?

A I think we did want—he wanted to see something in print.

I think he expressed several times about the trading halt and this sort of thing.

* * *

[R. 8746] Q In this connection did he make any mention of trying to check out the feasibility of the alleged scheme with his clients?

A That I don't remember. I frankly don't think his clients could have told him much about it, because I don't think they were—they were portfolio managers who didn't know beans about insurance operations.

I don't see how they could have known and I don't recall him saying that to me.

Q Did Mr. Dirks ever indicate to you why he was spending a good bit of his time and I guess some money investigating this whole Equity Funding matter?

[R. 8747] A The impression that I thought was twofold.

Q First, did he ever tell you why he was doing it in so many words?

A In so many words I can't remember him saying "Here's why I am doing it." The best I can do after these years is a recollection he was naturally inquisitive.

He's a very inquisitive person. I think he became intrigued the further he got into this thing and, secondly, he had some very important clients with a lot of stock.

Q Let me be clear in connection with the latter part of your answer. Was there anything he said or did that led you to believe that he was acting out of a motice [*sic*] to inform his clients?

A Yes. I believe that that was definitely part of his motivation.

I believe his action in coming out here and staying in frequent touch with them definitely indicated to me that one reason he was here was to find out what was going on for the benefit of his clients.

* * *

EXCERPTS OF TESTIMONY OF WILLIAM MALONEY

[R. 9954] WILLIAM MALONEY,

* * *

[R. 9955] Q What is your occupation, sir?
A Investment manager.

Q By whom are you employed?
A Institutional Capital Corporation, Chicago.

* * *

Q What is your position with Institutional Capital?
A President.

* * *

[R. 9973] Q Confining ourselves now to this conversation of the 19th.
A Right, yes.

Q Okay.
A * * * I also asked him how many people he had told this to.

I think he told me I was the second or third person.

I said, you know, these are pretty serious charges—pretty serious allegations you are bringing and could have serious effects.

I said, does your firm know that you are promulgating this stuff.

He told me they did.

I asked him if—if it was that serious why he didn't go to the stock exchange of [*sic*] the insurance commissioners or the SEC with it because it would mean an awful lot of it [*sic*] were true.

It would be disastrous obviously.

If it wasn't true he'd have tremendous volatility in the stock.

[R. 9974] And I said, Ray, you have a good reputation for being a competent analyst.

I said, I think it is to your advantage to protect that reputation.

I said I think this may be inside—inside information and you better check it out.

I asked him if he had confronted Goldblum with this information.

He said he had not and that he was planning to go out there in a couple of weeks.

I guess he gave me a date, the 27th of March or something, the 28th.

I told him I didn't think that was good enough, we owned the security.

But I thought that he ought to get on an airplane and go out and confront Stanley Goldblum with all these things and call me back.

And since I wanted him to go I said, if you go I will pay your expenses out there.

So Ray went out there.

* * *

[R. 9981] Q I think you testified that you asked Mr. Dirks why he had not reported this or if he had reported it to the SEC—

A Right.

Q —or the stock exchange or the insurance regulators?

A Yes.

Q Did he reply to that?

A I never got a satisfactory—satisfactory answer as far as I was concerned from Mr. Dirks on that subject.

Q Did Mr. Dirks express any feeling of his regarding the SEC or the stock exchange to you?

[R. 9982] A I cannot recall.

Q Did you have any discussion with Mr. Dirks regrrding [*sic*] the possible effect on the market for Equity Funding securities?

A Oh, yes, I mentioned that in my earlier testimony.

If it were true, obviously it was a disaster.

If it weren't true you could have a sudden drop and I remember telling Ray that the situation was bigger than my clients holding and his good reputation.

There were a lot of little people that owned this security and if it had a precipitous drop they could go out of the bottom and it could come back again.

And I thought he had a great professional responsibility to conduct himself properly, to avoid this type of situation happening.

Q Did you specifically discuss with him what possible effect would be [*sic*] if larger institutional sellers started liquidating their holdings in Equity Funding?

A No.

MR. SIMONDS: Objection.

A No.

MR. SIMONDS: I will withdraw it but I prefer we don't have [*sic*] leading questions that attempt to put in [R. 9983] this witness' mind conversation he can't otherwise recall.

JUDGE MARKUN: I will admonish counsel to avoid leading.

MR. KARLEN: Thank you, your Honor.

Q You testified that you raised the possibility with Mr. Dirks that this might be inside information?

A Yes.

Q Can you elaborate any further on that portion of the discussion?

A Well, when I said it may be inside information Ray said how can it be inside information, they are former employees.

I said, yes, but they know something presumably the investing public doesn't know.

And I reminded him of the case of the lums [*sic*] and the Bausch & Lomb case and the nebulousness of the rule regard-

ing inside information and thought that there again he might be injuring a good professional record.

And I made the point several times over that I don't buy stocks on this kind of information. I certainly don't sell them on that kind of information.

Q What did you tell Mr. Dirks about the Bausch & Lomb and Lums case?

A Well, I think I just told him that Wally [R. 9984] McCullum from Falkner, I believe Falkner Dawkins & Sullivan, went out there, got some information and he came back and thought he was doing a good analytical job and published it and there was quite a bit of repercussion.

And at the Lums case I guess that was up in IDS where they presumably had some inside information and took—acted on it and there was a lot of trouble and litigation.

And I thought that Ray being the professional that he is that he ought to consider that.

Q Did you suggest that Mr. Dirks take any action?

A Yes.

I suggested that—as I have testified, I suggested that he go out to California, confront Stanley as soon as possible, that day, call me as soon as he got out there and let me know what was going on.

* * *

EXCERPTS OF TESTIMONY OF DONALD KRAMER

[R.10,500] DONALD KRAMER.

[R.10,501] Q Directing your attention, Mr. Kramer, to the month of March of 1973.

A Yes.

Q Where were you employed at that time?

A I was a general partner of Oppenheimer & Company.

Q And could you describe what your duties and responsibilities were at that time?

A Yes.

I was in the research department. I was a research analyst specializing in insurance stocks.

I also served the corporate finance department and some managerial responsibility in research.

Q As an analyst, did there come a time when you became interested in the securities of Equity Funding Corporation of America?

A Yes, I did.

[R.10,502] Q When was that, sir?

A Somewhere in 1970 or '71.

* * *

[R.10,540] Q Mr. Kramer, prior to March 27th, 1973, did you know or had you heard that Equity Funding issued and was carrying on its books and records false or fictitious insurance policies?

A No.

Q Did you know or had you heard that Equity Funding had co-insured or reinsured fictitious insurance policies?

A No.

Q In March of 1973, Mr. Kramer, were you familiar with the terms co-insurance?

A Yes, I was.

Q Were you familiar with those terms as Equity Funding applied them?

A Very much so.

Q How would you become familiar with them?

A Well, Equity Funding, in order to finance its rapid growth, was forced, I thought, to co-insure [R. 10,541] large portions of its business.

By so doing, essentially they were selling future profits for current dollars, current income.

And since an analyst is concerned with the durability and persistency of a company's growth, the sale of its future profits now made it somewhat less attractive than it might have been if they were able to keep that business on their books.

And so I spent a fair amount of time getting involved in analysis and understanding of their co-insurance.

They supplied me with something called a co-insurance white paper and they also looked at some of their—the terms and conditions of their co-insurance agreement to see how they operated and spent a fair amount of time with management learning how I thought these things operated.

Q Based on your analysis, Mr. Kramer, did you form an opinion as to the propriety of Equity Funding's co-insurance operation?

A I thought they were bon [*sic*] fide sales.

Q Prior to March 27, 1973, did you know or had you heard that Equity Funding had fraudulent books and records to support fictitious policies in co-insurance?

A No, I don't remember hearing anything of that kind.

[R.10,542] Q Prior to March 27, 1973, had you heard that Equity Funding had issued fake and fraudulent financial statements in order to support fictitious policies and co-insurance?

A Not with regard to fictitious policies or co-insurance.

Q Prior to March 27, 1973, did you know or had you heard that top officers and directors of Equity Funding were

involved in any of the activities that I have just described in my previous questions to you?

A No.

Q So that the record will be clear, Mr. Kramer, did you hear any of the things that I have just mentioned in my previous questions on March 27th as opposed to prior to?

A No.

Q On or prior to March 27, 1973, Mr. Kramer, had you heard anything that led you to believe that there was fraud at Equity Funding?

A No.

Q Did there come a time when you learned that there was fraud at Equity Funding?

A Yes, obviously.

* * *

EXCERPT OF DIVISION EXHIBIT 17

DIRKS BROTHERS
7 Dey Street
New York, New York 10007
Tel. (212) 349-5700

A Division of Delafield Childs Inc.
Member, New York Stock Exchange, Inc.

February 15, 1972

INSURANCE CONFIDENTIAL

Ideas on Insurance Stocks

By Raymond L. Dirks

This weekly scandal sheet is supposed to be distributed to those investors who intend to give brokerage business to Delafield Childs, Dirks Brothers Division (Insurance Section). If you are not in this category, please scrawl your name on the first edition and return to us in the enclosed self-addressed envelope (XEROX copies not allowed), and we won't bother you again, we promise.

As advertised in the current Institutional Investor, our insurance stocks expertise resides in the following individuals, each of whom puts out regular Newsletters:

Ray Dirks—*INSURANCE CONFIDENTIAL*

Allen Gorrelick—*Life Insurance*

Gerald Lewinsohn—*Property-Liability Insurance*

Carl Walker - *MANAGEERS (Insurance Conglomerates)*

Fred Hackenburg - *Insurance Brokers, Rapid Growth •Stocks*

No salesmen will call because we don't have any—just analysts.

To give us the business, please call in your orders to the Delafield Childs trading department at 212-832-1033. Ask for Helaine or Bud, Judy or Jim. They execute orders on the NYSE, ASE, OTC, ETC.

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* * *

DIVISION EXHIBIT 24

BROKERAGE REQUEST

FIRM: Delafield Childs (~~Ray Dirks~~)

ADDRESS:

REP: Ray Dirks

AMOUNT: 4,000 - 5,000

REASON: Insurance Co. reports & recommendations

3-15-73 $3,956.20

REQUESTED BY: /s/

APPROVED BY: /s/

RECEIVED TBCIII
Mar. 15 10:15 AM '73

T-904 6/72

DIVISION EXHIBIT 80B

Address Reply To
UNITED STATES
ATTORNEY
AND REFER TO
INITIALS AND NUMBER

WDK:EAN:WJR:ycg
(FTS) 798-3036

SEC. EXCH. COMM.
N.Y. REGIONAL OFFICE
RECEIVED
MAY 24 1976

☒ Moran ☐ ____
☒ Malawsky ☐ ____
☐ Jacob ☐ ____

United States Department of Justice

UNITED STATES ATTORNEY

CENTRAL DISTRICT OF CALIFORNIA
U.S. COURT HOUSE
312 NO. SPRING STREET
LOS ANGELES, CALIFORNIA 90012

May 21, 1976

Mr. Roger Deitz
Special Counsel
Securities & Exchange Commission
26 Federal Plaza
New York, New York 10007

Re: United States v. Stanley Goldblum et al. CR 13390-JWC-CD

Dear Mr. Deitz:

Pursuant to your request enclosed please find a copy of a summary of the convictions in the above-entitled matter.

If we can be of further assistance to you, please let us know.

Very truly yours,

WILLIAM D. KELLER
United States Attorney

/s/

WILLIAM JOHN RATHJE
Assistant Chief,
Criminal Division

Enclosure

UNITED STATES v. GOLDBLUM, ET AL., CASE #13390-JWC-CD

DEFENDANT	GUILTY	SENTENCE
STANLEY GOLDBLUM	COUNTS 1, 10, 25, 70, 77	8 YEARS IMPRISONMENT AND $20,000 FINE
SAMUEL B. LOWELL	COUNTS 1, 24, 25, 26, 27	5 YEARS IMPRISONMENT
FRED LEVIN	COUNTS 1, 26, 91, 92	5 YEARS IMPRISONMENT
ARTHUR S. LEWIS	COUNTS 1, 47, 100	3 YEARS IMPRISONMENT
LLOYD D. EDENS	COUNTS 1, 63, 99	3 YEARS IMPRISONMENT
JAMES BANKS	COUNTS 1, 60, 97	3 YEARS IMPRISONMENT
JAMES C. SMITH	COUNTS 1, 44, 52	2 YEARS IMPRISONMENT
MICHAEL E. SULTAN	COUNTS 1, 24, 85	2 YEARS IMPRISONMENT
DAVID J. CAPO	COUNTS 1, 41, 42	2 YEARS IMPRISONMENT
LARRY G. COLLINS	COUNTS 1, 90, 98	2 YEARS IMPRISONMENT
WILLIAM MERCADO	COUNT 1	2 YEARS IMPRISONMENT - SUSPENDED: 6 MONTHS INCARCERATION (WORK FURLOUGH) PLUS 3 YEARS PROBATION
DONALD MC CLELLAN	COUNTS 1, 103	2 YEARS IMPRISONMENT - SUSPENDED: 6 MONTHS INCARCERATION (WORK FURLOUGH) PLUS 3 YEARS PROBATION

DEFENDANT	GUILTY	SENTENCE
LESTER M. KELLER	COUNTS 1, 30	2 YEARS IMPRISONMENT - SUSPENDED: 3 MONTHS INCARCERATION (WORK FURLOUGH) PLUS 3 YEARS PROBATION
ALAN L. GREEN	COUNTS 1, 53	2 YEARS IMPRISONMENT - SUSPENDED: 3 MONTHS INCARCERATION (WORK FURLOUGH) PLUS 3 YEARS PROBATION
JEROME H. EVANS	COUNT 1	1 YEAR IMPRISONMENT- SUSPENDED: $5,000 FINE PLUS 2 YEARS PROBATION
GARY S. BECKERMAN	COUNT 1	2 YEARS IMPRISONMENT - SUSPENDED: $1,000 FINE PLUS 1 YEAR PROBATION
WILLIAM E. SYMONDS	COUNT 1	2 YEARS IMPRISONMENT - SUSPENDED: $1,000 FINE PLUS 1 YEAR PROBATION
MARK C. LEWIS	COUNT 1	2 YEARS PROBATION
RICHARD GARDENIER	ONE COUNT OF A SUPERSEDING INFORMATION	3 YEARS PROBATION
JULIAN S. H. WEINER	COUNTS 6, 10, 11, 12, 13, 14, 75, 78, 80, 84	2 YEARS IMPRISONMENT - SUSPENDED: 3 MONTHS INCARCERATION PLUS 4 YEARS PROBATION AND 2,000 HOURS OF COMMUNITY SERVICE

DEFENDANT	GUILTY	SENTENCE
MARVIN A. LICHTIG	COUNTS 6, 10, 11, 12, 13, 14, 75, 76, 77, 79, 81, 82, 83	2 YEARS IMPRISONMENT - SUSPENDED: 3 MONTHS INCARCERATION PLUS 4 YEARS PROBATION AND 2,000 HOURS OF COMMUNITY SERVICE
SOLOMON BLOCK	COUNTS 10, 11, 12, 13, 14, 80, 84 (NOT GUILTY COUNTS 6, 78)	2 YEARS IMPRISONMENT - SUSPENDED: 3 MONTHS INCARCERATION PLUS 4 YEARS PROBATION AND 2,000 HOURS OF COMMUNITY SERVICE

ALL REMAINING CHARGES AGAINST
ALL DEFENDANTS HAVE BEEN DISMISSED.

DIRKS EXHIBIT D

Administrative Proceeding
File No. 3-5068

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of

THE BOSTON COMPANY INSTITUTIONAL INVESTORS, INC. *et al.*

STIPULATIONS BETWEEN THE DIVISION OF ENFORCEMENT AND RAYMOND L. DIRKS

It is hereby stipulated between the Division of Enforcement and Raymond L. Dirks, as follows:

* * *

STIPULATION NO. 12

Neither Raymond L. Dirks nor the company at which he was then employed made any trade of Equity Funding stock or debentures during March 1973.

STIPULATION NO. 13

Neither Raymond L. Dirks nor the company by which he was then employed received any commission, bonus, compensation or other remuneration, directly or indirectly, from any person to whom Mr. Dirks provided information concerning Equity Funding.

* * *

DIRKS EXHIBIT P

February 14, 1972

MEMORANDUM OF PERSONAL INTERVIEW

Person Interviewed:	William Thomas Mercado 5711 Mistridge Road Palos Verdes Peninsula, California 90274 Home phone: (213) 377-7594 Current Business Address: The Larwin Company 9100 Wilshire Blvd. Beverly Hills, California 90212 Telephone: (213) 878-3550
Persons Conducting Interview:	Martin I. Robins, Attorneys Walter McCormies, Attorneys Los Angeles Branch Office
Date and Place of Interview:	February 2, 1972 Los Angeles Branch Office
Subject:	Equity Funding Corporation of America

Mr. Mercado's employment with the Larwin Company begins on February 7, 1972. His position will be Director of Corporate Management Systems.

Memorandum of Personal Interview
Equity Funding Corporation of America
February 14, 1972

His previous employment with Equity Funding Corporation of America (Equity) began on October 15, 1969. From October 15, 1969 to March 15, 1970, he was Director of Financial Services. From March 15, 1970 to July 1, 1971 he was Director of Corporate Management Information and from July 1, 1971 to January 28, 1972 he was Director of Corporate Planning and Development. Mercado stated that although he left Equity on January 28, 1972, he told Stanley Goldblum, president of Equity, that his services were available until February 4, 1972. However, they had not as of the date of this interview requested his services.

He stated that he had resigned when asked why he was no longer employed by Equity. When asked why he had resigned, he stated that it was due to serious disagreements with his immediate supervisor, Samuel B. Lowell (Lowell). When asked for specifics, he stated that Lowell had continuously interferred in his (Mercado's) areas of responsibility and decision making. He told us that since he was being paid as an executive officer to carry out certain responsibilities and make decisions with respect to such responsibilities, he felt that he should have been permitted to do so without Lowell's constant interference. He went on to say that he had brought such matters to the attention of Goldblum but felt the president had not acted to resolve the situation. Hence, he resigned.

During the interview Mercado diagramed Equity's table of organization (Attachment 1). However, he told us that the three persons who really ran the organization were: Stanley Goldblum, the president; Samuel B. Lowell, executive vice-president, finance; and Fred Levin, executive vice-president, Marketing. He also diagramed what he could recall as to Lowell's immediate responsibilities (Attachment 2) and Levin's immediate responsibilities (Attachment 3).

Mercado also told us that Equity Funding Corporation of America was more of a holding company than an operating

company and that its real function was to supervise and control about twenty (20) totally owned subsidiaries. Several such subsidiaries named by him were: Equity Funding Life Insurance Co. (a California corporation); Bankers' National Life Insurance Co. (corporate offices in New Jersey); North American Equity Securities Corp. (a California based registered broker-dealer); and Bishop's Bank (a Bermuda based bank). He said that the corporation, through its subsidiaries, had a sales force of about 8,000 salesmen, all duly licensed to sell life insurance and securities.

Mercado's responsibility as Director of Corporate Planning and Development (the last position that he held) was in the computer programming area. All information considered relevant about subject corporation or its subsidiaries went into the computers. While he is an accountant by education and experience, it was not his responsibility to prepare, review or verify accounting information before it was put into the computer system. He stated that accounting information was tightly controlled by Lowell and Michael Sultan (in charge of the Corporate Controllership Division). He told us he had heard many rumors about the company, particularly during the early days of his employment, but that he has no present personal knowledge of any questionable accounting practices being performed and, further, he has no reason to believe that there are any such questionable practices being committed.

He recalled that when he first started to work he went to the president and told him about these rumors. Goldblum assured him that there was no basis for them. He also said that when he first came with the corporation, he observed several questionable accounting practices which he did not specify. He further stated, however, that he was of the opinion that they had occurred because the corporation had been founded by salesmen and was sales oriented and did not have qualified accountants who could have prevented such practices. Since then, he

said the corporation has employed qualified accountants and there has been considerable improvement in accounting operations. If proper accounting and business practices are not presently being followed, he would blame it on lack of experience and expertise on the part of the executive officers (who are mostly in their thirty's) and lack of control by those same officers due to their numerous and variant responsibilities. He stated that some have as many as thirty or forty specific responsibilities.

Mercado has always found objectionable the fact that many of the subsidiaries have their corporate audits performed by nationally known audit firms, such as Haskins and Sells and Peat, Marwick, but that the holding corporation is audited by the small local firm of Wolfson Weiner Ratoff and Lapin. That, of course, makes the latter firm responsible for reconciling all of the audits performed on the subsidiaries by the larger auditing firms. The president's explanation for doing it that way was that the local firm had been auditing them for a long time. Mercado named Sol Block as the person in charge of the auditing for Wolfson Weiner Ratoff and Lapin. The firm's address is 8899 Beverly Boulevard, Los Angeles, California 90048, telephone: (213) 272-4181.

Mercado told us that while his feelings about the company are not friendly, he is satisfied that management at this time is interested in improving its accounting practices and is doing so.

In response to an inquiry as to anyone who had recently left the company who might have personal knowledge of the inside working of the company, Mercado stated that a Mr. Leone, who was staff assistant to Lowell, left the corporation about eight months ago and that he had worked under Lowell for about a year. Mercado thought Leone may have been terminated but doesn't know what the reason would have been for the

termination. He believes that Leone is now locally employed by Washington Thrift & Loan and that he would have a more first hand knowledge of the accounting and bookkeeping practices of the company.

Martin I. Robins
Attorney

Walter McCormies
Attorney

Attachments

cc:SFRO
MIR/mla

DIRKS EXHIBIT Q

May 8, 1972

MEMORANDUM OF INTERVIEW

Persons Interviewed:	James Jess 606 South Hill Street Los Angeles, California and William Thomas Mercado 5711 Mistridge Road Palos Verdes Peninsula, California
Person Conducting Interview:	Martin I. Robins, Attorney Walter McCormies, Attorney Los Angeles Regional Office
Date and Place of Interview:	May 5, 1972 Los Angeles Regional Office
Subject:	Equity Funding Corporation of America

On the above date Mr. Jess, an attorney, visited this office with his client, Mr. Mercado, who had been informally interviewed on February 2, 1972 by staff attorneys Robins and McCormies. Mr. Mercado had appeared on that date without an attorney as the result of a telephone call from Mr. Robins requesting information about the operation and accounting practices of the Equity Funding complex, by whom he had recently been employed (see memorandum of interview dated February 7, 1972). Mr. Mercado had come to this office at his own suggestion as he preferred that to giving information over the telephone. At the time of the interview on February 2, 1972 he had been advised that he could have an attorney present. He chose to be interviewed without his attorney, stating that he did not feel it necessary that one be present.

To start the meeting of May 5, 1972, Mr. Jess was asked why he had asked us to see him. He advised that Mr. Mercado had previously talked to us without an attorney being present and was concerned that he may have given information which might tend to incriminate him. He was informed that Mr: [*sic*] Mercado had appeared voluntarily and had been advised of his rights, even though we did not consider him to be a target of our inquiries. He was advised that if Mr. Mercado's information had indicated that it might involve violations by him, he would have again been told of his right against self-incrimination and, if appropriate, our interview would have been suspended until he could appear with an attorney. Mr. Mercado agreed that he did not feel he had been questioned unfairly.

Mr. Jess explained that since he was inexperienced in securities matters, he had discussed the circumstances of our questioning his client with other attorneys who had dealt with this office. These attorneys had indicated that they would not permit their clients to give any testimony to the SEC because they could never tell in what way it might be used against them. Mr. Jess observed that while he was reassured by this interview that we had not sought to trap his client into damaging statements, he would nevertheless feel more at ease if we would give his client a grant of immunity.

It was explained to Mr. Jess that members of the staff had no authority to make such a grant. That such grants could only be given by the Commission and the U.S. Attorney.

It was suggested to Mr. Jess that if Mr. Mercado had any additional information or leads to furnish with respect to any specific accounting practices by Equity we would be happy to receive it. He stated that he would discuss the matter further with Mr. Mercado to determine whether he might be in possession of such information. If he found this to be so, and that such information could be given to us without any self-incrimination by his client, he would be in touch with this office again.

Before leaving, both Mr. Mercado and Mr. Jess indicated that they were also concerned with Mr. Mercado's status in his new position if it became known that he had talked about the company which had previously employed him. Mr. Mercado remarked that Equity Funding was a big company with a lot of economic power, and that he did not want to jeopardize his future.

Martin I. Robins
Attorney

Walter McCormies
Attorney

DIRKS EXHIBIT R

Office Memorandum SECURITIES AND EXCHANGE COMMISSION

Date: August 31, 1973

TO : Irving M. Pollack
Division of Enforcement

FROM : Gerald E. Boltz, Administrator
Los Angeles Regional Office

SUBJECT: Equity Funding Corporation of America
(File No. LA-46)

Pursuant to the Request received through the Division of Enforcement on August 29, 1973 for a chronology of events relating to the subject company in March, 1973, the following information is supplied:

Friday, March 23, 1973[1]

Ralph H. Erickson, Assistant General Counsel, Los Angeles Regional Office, received a telephone call from William Blundell, Bureau Chief of the Los Angeles office of the Wall Street Journal, inquiring whether the Commission was investigating Equity Funding. Mr. Erickson furnished no information but suggested Blundell may wish to speak with Stan Sporkin, Deputy Director, Division of Enforcement. Later that day Gerald E. Boltz, Regional Administrator, received a telephone call while he was at home ill, wherein Sporkin advised that Blundell had called him and that Blundell had information concerning some possibly fraudulent activity at Equity Funding. Gerald Boltz thereupon called Ralph H. Erickson to discuss setting up an appointment with Blundell to obtain this

[1] This chronology begins on March 23, 1973 as that was the first day we began to obtain information indicating a substantial fraud at Equity Funding. (See Background Section of this memo for events occurring prior to March 23, 1973.)

information. John Peloso of the New York Regional Office called Mike Donahue of the Los Angeles office to advise he heard rumors on the "street" re Equity Funding, but no details.

Monday, March 26, 1973, 11:40 a.m.

Ralph H Erickson received a telephone call from Herb Lawson, Wall Street Journal, who indicated that there was talk in the street concerning what may be the "biggest insurance fraud in history" at Equity Funding.

11:45 a.m.

Erickson telephoned Sporkin reporting Lawson's comments and discussed possible trading suspension.

11:55 a.m.

Erickson called the Los Angeles office of Haskins & Sells to discuss financial statements of Equity Funding.

Initial phone call resulted in two additional telephone conversations with Haskins & Sells' offices that afternoon; no information tending to verify rumors was obtained; company filings and financial statements examined by staff.

In Washington, Sporkin advises Commission of possible problem at Equity Funding.

6:00 p.m.

Messrs. Boltz, Erickson and Les Ogg of the Los Angeles office met with William Blundell at the Los Angeles offices of the Wall Street Journal. Blundell recited in some detail information he had obtained from former employees of Equity Funding and further described the activities of one Ray Dirks in obtaining similar information. Blundell expressed his concern as to the reliability of the information and stated he was not sure his informants would talk to the SEC. Blundell was requested to contact his informants that evening in an attempt to convince them to come to the SEC with their information. Subsequently, Gerald Boltz received telephone calls at his home at approximately 8:00 to 9:00 p.m. from Messrs. Majerus and Hopper,

wherein they offered to furnish information concerning Equity Funding to the Commission. Boltz asked them to appear the following morning to give statements.

Tuesday, March 27, 1973

Messrs. Dirks, Majerus and Hopper appeared in the morning and were introduced by Blundell. Majerus' statement was initially taken off-the-record by Boltz and Mike Donahue (LARO) (later on April 2 his on-the-record statement was taken). Concurrently, Messrs. Dirks and Hopper were interrogated on-the-record throughout the day on March 27 (these interrogations continued throughout the balance of the week). Conversations were also held between members of the staff and Larry Williams, Compliance Counsel for Equity Funding, wherein it was requested that the principal executives of the company and the company's accountants appear for an on-the-record interrogation on Thursday, March 29 in this matter. Further, the principal executives were urged to immediately furnish affidavits denying all rumors of fraud. Boltz conferred in a telephone conversation with Stan Sporkin and Irving M. Pollack. Discussion centered on whether we were witnessing a "bear" raid accompanied by the intentional dissemination of rumors or an actual fraud at the company, or both. It was finally agreed that based upon information and testimony just obtained from Majerus and Hopper, as well as recent market activity in Equity Funding stock sales, that trading should be suspended by the Commission immediately; this recommendation was presented to the Commission. The staff also met with the State of California Department of Insurance; we were apprised that they had no further information to furnish. Ogg and other staff members related information obtained by the Commission staff to the state officials. Goldblum issued press release denying rumors.

Wednesday, March 28, 1973

SEC trading suspension in effect. Additional testimony and statements taken of witnesses Dirks, Ballint and Hill (the latter two being partners of Haskins & Sells). Further inquiry

of Larry Williams at Equity Funding re progress made on affidavits from company officials. Williams complained that the Commission's suspension of trading, which had been announced, was unjustified and terribly damaging to the company. Other members of the staff were involved in reviewing the company's filings with the Commission, checking information from brokers for possible insider sales and other related market activity.

Thursday, March 29, 1973

Larry Williams advised the staff that they were experiencing a delay in obtaining affidavits, that some of them might not be forthcoming and that interrogation must be delayed until next day. Executives of Equity Funding might retain personal counsel. Other aspects of the investigation continued. Recommendation for injunctive action discussed with home office. Representatives of First National City Bank provide information to Division of Enforcement of illegal Equity Funding activities.

Friday, March 30, 1973

An on-the-record conference and interrogation of representatives of Seidman & Seidman and Haskins & Sells (also present was Larry Williams of the company). Following this interrogation, Williams furnished information indicating that Stanley Goldblum, president of Equity Funding, might have been selling securities of Equity Funding through Dishy-Easton & Co. Telephone calls were placed to the Division of Enforcement, Mr. Sporkin, who in turn contacted Dishy-Easton in order to freeze funds and securities in the Goldblum account. Other broker-dealers likely to have accounts for insiders of Equity Funding were checked in an attempt to freeze funds or securities therein. Equity Funding retained Buchalter, Nemer, Fields & Savitch law firm as general counsel. Conferences held with the Buchalter firm; company employees interviewed.

State of California Department of Insurance urged by staff to seize company to preserve records.[2]

Saturday, March 31, 1973

Conferences held between the staff, company counsel and members of the board of Equity Funding. Also a conference held with Seidman & Seidman relating information they were volunteering. Discussion also held re integrity of the company's records, preventing the erasure of tapes, etc.

Sunday, April 1, 1973

Further conferences with company counsel and certain employee informants were questioned concerning board of directors meeting held that day wherein officers of Equity Funding resigned. Complaint for injunctive and other moving papers prepared and discussions held concerning possible Court appointed board based upon the suggested resignation of all present directors of Equity Funding. Discussion also held concerning appointment of a special investigator for Equity Funding by the Court. Met with bank officials re company's outstanding loans.

Monday, April 2, 1973

Commission injunctive action filed alleging a scheme to defraud in violation of Section 10b and Rule 10b-5 and false filings by Equity Funding. Conference held with U. S. District Judge Harry Pragerson. Candidates for possible board members contacted. Attorney Lewis Merriefield contacted re possible appointment as special investigator. Initial Wall Street Journal article appears describing Equity Funding fraud. Conferences

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[2] The California Insurance Department was not fully convinced we had sufficient evidence to warrant seizure, but agreed to this procedure. Larry Baker, Deputy Commissioner, later stated: "At that point we had not found one fake policy. We had nothing but stories. Our hearts were in our mouths."

held with principal bank lenders re further extensions of credit to Equity Funding.

Tuesday, April 3, 1973

Equity Funding Corporation of America consents to an order of permanent injunction, a Court appointed board of directors and appointment of a special investigator. Conferences held by the staff with Buchalter, Nemer, Fields & Savitch re company's financial and operational crisis.

Wednesday, April 4, 1973

Further conference with company counsel re company's condition. Further information obtained in an attempt to avoid reorganization under the Bankruptcy Act from employees and other informants re nature of fraud.

Thursday, April 5, 1973

Equity Funding Corporation of America files a petition under Chapter X of the Bankruptcy Act.

Background

During the 1968-1971 period, the Los Angeles office received complaints about the "back office" operations of Equity Funding resulting from delays in effecting customer orders. The staff made inquiries, and as a result the company changed certain procedures and hired an experienced compliance counsel in 1969.

In late 1971 a local attorney reported hearing of possible misstated assets due to improper accounting at Equity Funding. An inquiry was undertaken wherein present and former financial officers and accountants of the company were interrogated. This inquiry indicated that in the early 1960's the company had been managed by essentially "sales" people, who had not emphasized record keeping, so that by the mid 1960's the records were in a poor state. Subsequently, the company had corrected this situation by hiring several qualified accountants. Present and former officials questioned furnished no information concerning any other improper practices. (Sub-

sequent investigation in mid 1973 showed that at least one of these witnesses withheld information from the staff and apparently attempted to shake down Equity's management in return for not divulging the true facts about the company.) In January, 1972 the Los Angeles office recommended a scheduled 600-man-hour mutual fund inspection at Equity. The staff proposed to the California Corporation Commission and the California Insurance Department the formation of a joint task force to conduct inspections of several local insurance funding type companies. This was proposed in view of the substantial manpower requirements of these inspections.[3] Subsequently, an inspection was conducted of Zenith Funding Corporation as, in part, a training exercise for the task force group, preparatory to inspecting the much larger Equity Funding.

On March 9, 1973 Edward Germann of the California Department of Insurance discussed Equity Funding with Les Ogg, Chief of the Investment Company Unit in Los Angeles (see attached memorandum). Ogg concluded that Germann furnished no new information but requested Germann to obtain further details and provide us with the information.[4] On March 12 an inspector from the state of Illinois commenced an

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[3] The Los Angeles office was then a branch office with approximately 25 employees. In April, 1972 the newly appointed Regional Administrator, Mr. Boltz, caused the office to become a regional office, and the staff was increased although such was limited by government and Commission employment freezes. (The Los Angeles office Investment Company Inspection Unit then consisted of two attorneys and one examiner, who were also responsible for all regional investment company investigations and litigation.)

[4] Due to a then pending court hearing re *SEC* v. *Goldstein Samuelson, Inc.*, secretarial personnel did not transcribe Ogg's memorandum, dictated March 9, until March 16. The memorandum was routed to Mr. Boltz who first saw it on March 26, 1973, as he was at home ill during the previous week.

examination at Equity Funding Life Insurance Company and was joined on March 16 by an examiner from the California Department of Insurance. However, by March 30 they had not found any fake policies or other falsified records.

Attachment

GEB/rl

BOSTON CO. III
EXHIBIT HHH

March 16, 1973

Gerald E. Boltz

Leslie L. Ogg

Equity Funding Corporation
811-278

RE: Conference between Edward J. Germann, Division Chief, Company Information and Analysis Division, State of California - Department of Insurance and Leslie L. Ogg on March 9, 1973 at 2:00 p.m.

Mr. Germann stated that he had received a telephone call from the Insurance Commissioner's Office, State of New York. This telephone call was precipitated by the proposed acquisition of three affiliated insurance companies by Equity Funding Corporation (Equity Funding), the major one of which is incorporated in New York, while the other two are a California corporation, and a Dutch corporation. While this acquisition must ultimately be approved by the California Department of Insurance, no application has yet been filed.

The New York Insurance Commissioner's office was concerned because an informant, an ex-employee of Equity Funding in New Jersey, had come to their offices alleging that Equity Funding was overstating assets on their financial statements, issuing confirmations for sale of Fund's shares - which shares were in fact not issued until some later date, and delaying the payments for a substantial period of time to investors and policy holders who canceled programs.

Mr. Germann stated that when his office received the application from Equity Funding to acquire these three insurance companies, that he had 60 days in which to act. He said he felt that his superiors were going to demand a full inspection of Equity Funding's operations because of the question raised by New York and asked what assistance I could be. I advised Mr.

Germann that similar allegations had been made before regarding this company and attempted to explain the Equity Funding program to him. He stated that it is possible this informant was an officer, perhaps a controller of the corporation, and if so, felt that such information probably was more substantial than past disgruntled employees. I agreed and suggested that he obtain as much detailed information as possible from the informant and that upon receipt of this information, we would set down with the Division of Insurance, as well as the Department of Corporations, and decide what type of task force might prove productive in this matter.

However, if the informant cannot give detailed information, I suggest delaying any type of inspection of the Equity Funding operations until next year when more personnel are available.

LLO:md

ADMINISTRATIVE PROCEEDING
FILE NO. 3-5068

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of

THE BOSTON COMPANY INSTITUTIONAL INVESTORS, INC.
JOHN W. BRISTOL & CO., INC.
RAYMOND L. DIRKS
THE DREYFUS CORPORATION
MANNING & NAPIER
TOMLIN, ZIMMERMAN & PARMELEE, INC.

INITIAL DECISION

APPEARANCES:

Donald N. Malawsky, Associate Administrator, Enforcement, New York Regional Office; Jason R. Gettinger and Andrew N. Karlen, Attorneys; and Roger M. Deitz, Special Counsel, for the Division of Enforcement. Paul S. Maco assisted on the reply brief.

Marshal Simonds, Thomas J. Griffin, Jr. and Carol Goodman, of Goodwin, Procter and Hoar, Boston, Mass., for Respondent The Boston Company Institutional Investors, Inc.

Peter M. Brown, Claude P. Bordwine and Howard W. Burns, Jr., of Cadwalader, Wickersham & Taft, New York, N.Y., for Respondent John W. Bristol & Co., Inc.

David Bonderman and David Hird, of Arnold & Porter, Washington, D.C., for Respondent Raymond L. Dirks.

Lawrence Greenwald and Bruce H. Schneider, of Stroock & Stroock & Lavan, New York, N.Y., for Respondent The Dreyfus Corporation.

Robert C. Napier, of Napier & Lapine, Rochester, New York, for Respondent Manning & Napier.

Robert A. Meister, of Milgrim Thomajan & Jacobs, New York, N.Y., for Respondent Tomlin, Zimmerman & Parmelee, Inc.

BEFORE:

David J. Markun
Administrative Law Judge

I

THE PROCEEDING

This public proceeding was instituted by an Order of the Commission dated August 24, 1976, as amended on September 10, 1976 and on October 12, 1977 ("Order"), pursuant to Sections 15(b) and 19(h) of the Securities Exchange Act of 1934[1], Section 203(e) of the Investment Advisers Act of 1940[2], and Section 9(b) of the Investment Company Act of 1940[3], to determine whether one individual respondent and five corporate respondents wilfully violated or wilfully aided and abetted violations of Section 17(a) of the Securities Act of 1933[4] or Section 10(b) of the Exchange Act of 1934 and Rule 10b-5 thereunder[5], and the remedial action, if any, that might be appropriate in the public interest. In substance, the allegations of the Division of Enforcement ("Division") contained in the Order charge violations of the rule against inside information trading in connection with various sales of the securities of Equity Funding Corporation of America in March of 1973 by the five corporate respondents on behalf of their clients.

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[1] 15 U.S.C. § 78o (b); 15 U.S.C. § 78s (h).

[2] 15 U.S.C. § 80b—3(e).

[3] 15 U.S.C. § 80a—9(b).

[4] 15 U.S.C. § 77q(a).

[5] 15 U.S.C. § 78j (b); 17 CFR 240.10b-5.

The evidentiary hearing was held in New York, New York, and, in part, in Los Angeles, California. All parties have been represented by counsel thoughout [*sic*] the proceeding. The parties have filed proposed findings of fact and conclusions of law and supporting briefs pursuant to the Commission's Rules of Practice (17 CFR 201.16). Respondents filed both joint proposed findings and conclusions and supporting memorandum and individual proposed findings and conclusions and memoranda.

The findings and conclusions herein are based upon the record and upon observation of the demeanor of the various witnesses. The standard of proof applied is that requiring proof by clear and convincing evidence.[6]

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[6] The Court of Appeals for the District of Columbia Circuit has held that in an administrative proceeding brought by the Commission to determine whether a broker-dealer and its president had violated antifraud provisions of the federal securities laws and in which the sanction in question involved "an expulsion or a substantial suspension order" the "clear and convincing" standard of proof rather than the long-standing "preponderance of evidence" standard of proof should have been applied. *Collins Securities Corporation* v. *S.E.C.*, 562 F. 2d 820, decided Aug. 12, 1977, as amended on denial of request for rehearing September 23, 1977. Although a petition for certiorari from the Supreme Court was not sought in *Collins*, the Commission has continued to assert in other proceedings that the preponderance of the evidence standard is legally sufficient in all administrative proceedings under the securities laws, e.g. *Charles W. Steadman* v. *S.E.C.*, No. 77-2415, currently pending in the Court of Appeals for the Fifth Circuit, an appeal from the Commission's decision in *Steadman Security Corporation, et al.*, Investment Company Act of 1940, Release No. 9830, June 29, 1977, 12 SEC Docket 1041, July 12, 1977. In the *Steadman* appeal the Commission urges that *Collins* conflicts with an earlier decision of that same circuit (*Abbett, Sommer & Co., Inc.* v. *Securities and Exchange Commission*, ['70-'71] Fed. Sec. L. Rep. [CCH] ¶ 92,813 (1970), cert. den., 401 U.S. 974 (1971)); with decisions of the Court of Appeals for the Second Circuit (*De Mammos*

II

FINDINGS OF FACT AND LAW

A. The Respondents; Background Concerning Their Knowledge Of And Interest In Equity Funding Prior To Hearing Alleged Inside Information In March, 1973.

EFCA

As noted, the corporation in whose securities the alleged illegal transactions occurred in violation of the inside-information proscription was Equity Funding Corporation of America ("EFCA" or "Equity Funding"), a California corporation with principal offices in Los Angeles. EFCA is not a respondent but some findings concerning it are essential to understanding related findings and conclusions.

From 1960 to 1966 EFCA had been essentially a marketing organization selling life insurance, shares in mutual funds, and funding programs combining the two. In 1967 it had embarked upon a diversification program that included the acquisition of investment companies, insurance companies, marketing com-

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v. *S.E.C.*, C.A. 2, No. 31469 (Oct. 13, 1967), affirming *James De Mammos*, 43 S.E.C. 333 (1967); *Wright* v. *S.E.C.*, 112 F. 2d 89 (C.A. 2, 1940); and with a long line of the Commission's decisions (*Richard C. Spangler, Inc.*, Securities Exchange Act Release No. 12104, 8 *SEC Docket* 1257 (February 12, 1976), *remanded on other grounds sub nom. Nassar and Co.* v. *Securities and Exchange Commission*, ['77-'78] Fed. Sec. L. Rep. [CCH] ¶ 96,185 (C.A. D.C., October 3, 1977); *Sidney Leavitt*, Securities Exchange Act Release No. 10013, 1 SEC Docket 1 (February 22, 1973); *M.V. Gray Investment, Inc.*, 44 S.E.C. 567, 575 (1971); *In re Norman Pollisky*, 42 S.E.C. 458, 459-460 (1967); *Underhill Securities Corp.*, 42 S.E.C. 689, 695 (1965); *White and Weld*, 3 S.E.C. 466, 539-540 (1938).) In view of the conflict among the Circuits on this point and in light of the forums available on any appeal that may be taken, it is concluded that the more appropriate course is to apply the "clear and convincing" standard of proof in this proceeding.

panies, a savings and loan association, certain foreign operations, partnerships in oil and gas exploration and cattle breeding, and a real estate development enterprise. Thus, by March, 1973 EFCA had taken on the aspect of a substantially diversified enterprise; nevertheless, its primary business continued to be sales of life insurance, mutual funds, and funding programs combining the two.

EFCA's insurance business was conducted through its subsidiaries, Equity Funding Life Insurance Company, domiciled in Illinois but with its principal offices in Los Angeles ("EFLIC"), Bankers National Life Insurance Company, Parsippany, New Jersey ("Bankers" or "Bankers National"), Northern Life Insurance Company, Seattle, Washington ("Northern"), and Equity Funding Life Insurance Company of New York, New York, a subsidiary of Bankers ("EFNY"). EFLIC's insurance products were marketed by EFCA's sales force, whereas the other insurance subsidiaries of EFCA primarily utilized general agents.

EFCA first issued its securities to the public in 1964. From time to time thereafter, EFCA issued notes, convertible debentures, and similar securities to the public.[7] Each of these was issued pursuant to a registration statement filed with the Commission. During this period EFCA filed periodic reports with the Commission pursuant to the Exchange Act.

EFCA common stock and its 5½ percent convertible subordinated debentures due in 1991 ("convertible debentures" or "debentures") were listed and traded on the New York Stock

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[7] These issues consisted of $2 million of 5½ percent capital subordinated notes due in 1980 with common stock purchase warrants, issued in 1965; $6 million of 5½ percent convertible debentures due in 1982, issued in 1967; $22 million of 9½ percent debentures due in 1990 with common stock purchase warrants, issued in 1970; and $38 million of 5½ percent convertible subordinated debentures due in 1991, issued in 1971.

Exchange. EFCA warrants were listed and traded on the American Stock Exchange.

Dirks

In March of 1973 Respondent Raymond L. Dirks ("Dirks") was a security analyst specializing in insurance stocks at Delafield Childs, a broker-dealer in New York, New York, having exclusively institutional clients. Earlier, in 1969, Dirks and his brother had formed a broker-dealership known as Dirks Brothers; that business was dissolved when Dirks joined Delafield Childs in December, 1971, where he became a senior vice president in charge of the Dirks Brothers Division, a research group comprising Dirks, his brother (whose expertise was in another area) and four other analysts that specialized in insurance stocks. Dirks's clients were exclusively institutions such as large commercial bank trust departments, investment companies, foundations, hedge funds, and other entities that managed securities portfolios.

The Dirks Brothers Division distributed information about and analyses of insurance companies to approximately 500 actual or potential institutional clients. Written reports were provided monthly on two or three companies and a statistical analysis covering about 50 companies was also issued about once a month. In addition to publishing materials, Dirks and his fellow analysts also contacted clients and potential clients personally with respect to insurance company securities.

Compensation for these analytical services of the Dirks Brothers Division was obtained indirectly from securities transactions directed by their clients through the Delafield Childs trading department. Such securities transactions did not necessarily or even usually involve insurance securities that were analyzed by Dirks Brothers.

Following graduation from college in 1955, Dirks until 1967 had been employed mainly as a securities analyst for various banks and firms.

On August 31, 1972, Dirks was the subject of a "profile" style article in the *Wall Street Journal*, which touched upon his background and methods as an analyst, and included evaluations of him, albeit sketchy, by his analyst peers. The article was generally favorable to Dirks, and among other things emphasized his dogged and sometimes innovative means for digging into relevant facts about a company. The article was written in the context of the difficulties small securities analyst firms were then experiencing and suggested that for at least some of them specialization might be the key to their survival.

While Dirks had not made any special analysis of Equity Funding, he was generally familiar with it from the time of its public offerings in the early '60s and had occasion from time to time to comment on the firm in conversations with other securities analysts and portfolio managers, and at least once in a written comment in the Dirks Brothers publication "Insurance Confidential - Ideas on Insurance Stocks" of February 15, 1972.

In 1971, at the request of EFCA's public relations firm, Dirks held a luncheon at which Stanley Goldblum, Chairman of the Board of Equity Funding, and other officers of EFCA, including Fred Levin and Sam Lowell, spoke to a gathering of analysts and portfolio managers.

Sometime after the day of the luncheon, Goldblum asked Dirks to attempt to ascertain whether Allen Abelson of *Barron's* was about to publish a (apparently unfavorable) story about EFCA, and Dirks did so, reporting that on the basis of his guarded inquiries he did not think there would be a report.

In early 1972, Goldblum called at Dirks's office and invited him, with another, to breakfast. Among other things discussed was EFCA's recent acquisition of Bankers National Life of New Jersey.

Dirks's other contacts with EFCA personnel prior to March of 1973 included encountering Fred Levin, Executive Vice President of EFCA and President of EFLIC, at a party, and

one meeting and a number of phone conversations with Patrick Hopper, then EFCA's Vice President for Investment.

Respondent III

Respondent The Boston Company Institutional Investors, Inc. ("III"), a Massachusetts corporation having its principal place of business in Boston, has been registered since 1970 as an investment adviser under Section 203[8] of the Investment Advisers Act of 1940. Respondent III is a subsidiary of The Boston Company, Inc. ("TBC" or "The Boston Company"), a holding company. In March, 1973, 58% of III was owned by TBC and the balance was owned by III officers Thomas W. Courtney, president, David A. Baker, senior vice president, Grayson M.P. Murphy, senior vice president, and John Wise, Jr. Other officers of III included Daniel Fuss and Gerald S. Zukowski, both vice presidents. William R. Moore was the firm's trader.

III rendered its investment advisory services primarily to pension and profit-sharing plans for the benefit of employees of business corporations and governmental entities.

In March, 1973, Courtney, Murphy, Baker and Fuss had primary account responsibility for client portfolios. Zukowski had also been designated a portfolio manager by that time but as of March 7th he had been delegated primary account responsibility for only one client. Wise, responsible for various marketing and administrative matters, had no primary account responsibilities, though he did participate in the management of some portfolios in a secondary or tertiary capacity. Each account had a designated primary, secondary, and tertiary portfolio manager. III also followed a practice under which a negative vote by two portfolio managers could veto a proposed transaction in a client's account.

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[8] 15 U.S.C. § 80b—3.

Between May 27, 1971 and February 28, 1973, III purchased 408,000 shares of EFCA common stock at a cost of approximately $14,550,000 and $850,000 in face amount of EFCA debentures, at a cost of approximately $950,000, on behalf of 20 of its clients. By the end of February, 1973, EFCA was the third largest holding in III client portfolios.

III's initiation of purchases of EFCA securities in the Spring of 1971 and its continuation of such purchases through late 1972 had been prompted by the fact that EFCA had historically enjoyed an outstanding growth record within the insurance industry. EFCA stock had appeared to the III portfolio managers to represent one of the better values in the market place in view of its attractive price and very low price-earnings ratio as compared with comparable growth stocks for that period.

Beginning in about September, 1972, senior management of The Boston Company had become more active in reviewing the activities of III, particularly in the person of William W. Wolbach, then president and chief operating officer of TBC and also a director of III. TBC management had become concerned that a substantial percentage of the stocks purchased for the III portfolios were not stocks followed by or recommended by TBC's Investment Research and Technology arm ("IRT"), an investment research group, and were not on the so-called monitor list of stocks approved by the Investment Strategy Group ("ISG") of TBC. From that time forward Wolbach had kept pressing Courtney to have III establish new investment policy guidelines that would call for substantially greater use of TBC's monitor list of stocks. After a number of meetings and discussions among the III portfolio managers, they had arrived at an informal understanding in late January or early February that their revised investment guidelines would aim at having not less than 80% of the aggregate composition of III portfolios consist of monitored stocks by the end of 1973. To begin implementation of that objective, it had been agreed that purchases of non-monitored stocks would be curtailed.

Beginning about December of 1972, portfolio managers at III had begun their own internal, somewhat informal analysis of EFCA. Zukowski had recently joined III, and since he had had some background in insurance stocks, he was the portfolio manager who primarily concerned himself with looking into EFCA; however, since EFCA stock was held by other portfolio managers as well, they too gathered information and views and exchanged information and opinions with Zukowski and with one another. The inquiry had included a one-day visit by Zukowski and Baker to EFCA's offices in Los Angeles, where they conferred with EFCA's president and various other officials sometime before Christmas of 1972. After the visit to EFCA's offices, III portfolio managers continued to talk to outside analysts, broker-dealers, and others with respect to matters that bore on evaluation of EFCA as a holding.

In late December Zukowski had talked about EFCA to Ray Dirks, whom he had earlier come to know in the course of their employment in another firm, but had found that Dirks was not closely following EFCA.

By memorandum of February 2, 1973, Courtney had requested Zukowski to prepare a comprehensive report on EFCA to be submitted to the ISG with a view to getting EFCA placed on the monitor list of approved stocks. Zukowski's draft report,[9] given to Courtney sometime between February 13 and February 23, was also circulated among the other portfolio managers. The draft was in the main positive but it did call attention as well to a number of specific negative factors respecting Equity Funding. Zukowski recommended to Courtney that the report not be submitted to the ISG because of the negative factors. After some further discussions with Zukowski and after the draft report had circulated among the other portfolio managers, Courtney had decided not to submit the report that would have sought to get EFCA onto the monitored list.

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[9] Division's Ex. 20.

Earlier, on February 14, 1973, Zukowski and Wise had attended a luncheon in Boston sponsored by Edwards & Hanly for EFCA officers Stanley Goldblum, Fred Levin and Sam Lowell. After the luncheon, Goldblum and Levin had visited III's offices.

The upshot of it all was that at the close of February and during the first week of March, 1973, there was among the portfolio managers at III no clear consensus regarding EFCA. However, there was a *prevailing* view among them that they should await an anticipated rebound in the price of the stock to the low or mid 30s before considering sale of some or all of the EFCA securities.

Bristol & Co.

Respondent John W. Bristol & Co., Inc. ("Bristol & Co."), a New York corporation having its principal place of business in the City of New York, has been registered as an investment adviser under the Investment Advisers Act since 1954. John W. Bristol ("Bristol") is Chairman of the Board and Chief Executive Officer of Bristol & Co., and held such positions in March, 1973.

Since 1968 Bristol & Co. has been a wholly owned subsidiary of TBC. However, Bristol & Co., under an express provision of the acquisition agreement, has operated with total autonomy in its investment decisions and was so operating in March, 1973. Thus, Bristol & Co. did not during the relevant period discuss with TBC or TBC's other subsidiaries Bristol & Co.'s investment decisions or the composition of its clients' investment portfolios.

Bristol & Co. is and was during the relevant period engaged in rendering investment advisory services to various organizations, financial institutions, pension funds and foundations, including a number of endowment funds for various schools, colleges, and universities. As of December, 1972 its clients' portfolios totalled some $1.5 billion.

Between December, 1971, and March 22, 1973, Bristol & Co. purchased for its clients a total of 457,000 shares of EFCA common stock and $200,000 face value of its convertible debentures. The Bristol Employees Profit-Sharing Plan purchased 600 EFCA shares in January, 1973.

The purchases were made because of EFCA's reported outstanding growth rate within the specialty insurance industry; its reportedly strong sales force that marketed a unique investment package combining elements of life insurance and mutual fund shares and interrelated financing; its apparent position for capitalizing on the growing interest in, and the Commission's recent approval of variable annuities for purchase by mutual funds; and its very low price/earnings ratio relative to comparable growth stocks.

Notwithstanding these positive factors, three individuals from three separate investment committees functioning for Bristol & Co.'s clients had expressed dissatisfaction with or lack of enthusiasm for the EFCA securities purchases.

As late as March 21, 1973, John Bristol personally sought and obtained permission from the Investment Committee of Princeton University to purchase EFCA stock. Because of subsequent events that are detailed in Part II B below, only 66,000 shares of the intended larger purchase of EFCA shares were bought on March 22, 1973.

The Dreyfus Corporation

Respondent The Dreyfus Corporation ("Dreyfus") has been registered as an investment adviser under Section 203 of the Investment Advisers Act of 1940 since December 10, 1971. In March, 1973, Dreyfus was the investment adviser for several registered mutual funds, including the Dreyfus Fund ("DF") and the Dreyfus Special Income Fund ("DSIF"). At that time Michael L. Quinn was employed by Dreyfus as a portfolio manager. He began to assume responsibility for DSIF's equity investments shortly before or in March, 1973, sharing that

responsibility with Joseph DiMartino. Howard Stein was the chief investment officer for DF and DSIF.

In March of 1973 Anthony Orphanos was a securities analyst with Dreyfus, covering the insurance industry for all portfolio managers. Among the other sources he consulted, Orphanos used the Dirks Brothers insurance stocks report and consulted Allen Gorrelick, an associate of Dirks's, from time to time. Orphanos knew Dirks primarily by reputation.

Prior to March, 1973, Quinn was not acquainted with Dirks.

In early 1973 the Dreyfus Fund acquired a position in EFCA, which had only recently become an investment eligible for purchase by mutual funds.

On March 21, 1973, DSIF purchased from Goldman, Sachs, & Co., acting as principal, $500,000 face amount of EFCA convertible debentures at a net cost of approximately $388,937.

Manning & Napier

Respondent Manning & Napier ("M & N") in March, 1973, was a partnership that had been registered since May of 1970 as an investment adviser under Section 203 of the Investment Advisers Act. Its office was then and is now located in Rochester, New York.[10]

In March, 1973, M & N provided counseling on a full time basis to individuals and tax-exempt pension funds. William Manning was a managing partner; he had final decision-making authority within the firm over all equity purchases and sales for client accounts.

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[10] In late 1973 Manning and Napier Advisers, Inc., a corporation, succeeded to the business of M & N and became registered as an investment adviser under Section 203. William Manning and William Napier each own 50% of M & N Advisers.

As of March of 1973, M & N serviced some 90 to 100 clients and managed about $20-25 million in assets.

On May 18 and 19 and June 7, 1972, M & N had purchased a total of 5,975 EFCA common shares for 19 of their client accounts.

Manning had become concerned with the price action of EFCA stock in the second half of 1972 and as a result had sold the holdings of three clients, based in part on the risk he felt those clients could take. In February, 1973, he sold out another client's EFCA shares after deciding that she could not afford the risk of further price diminution.

During the last half of 1972 and the first quarter of 1973 Manning discussed EFCA with William Reeves, a sales agent in EFCA's Rochester, New York, office, whom Manning considered to be financially knowledgeable. These discussions occurred when the two would meet without prearrangement at a local pub for an hour or two on Friday nights.

Manning had discussed with Reeves during the first quarter of 1973 two specific rumors about EFCA: (a) that the New York State Department of Insurance was investigating and might reverse EFCA's recent acquisition of Bankers National, and (b) that First National City Bank might decline to renew EFCA's credit line. Reeves checked out those rumors with the manager of EFCA's Rochester office and with EFCA's Eastern Sales Manager and reported to Manning that there was no substance to either rumor.

Manning considered insider selling of EFCA stock of importance and had monitored it closely during the first quarter of 1973. In February he had asked Reeves about such sales. Reeves, after checking with his branch manager and with Herbert Glaser, an executive vice-president of EFCA who worked in EFCA's home office, had reported that such sales were all for personal reasons such as home improvements, tax payments, and the like. Manning had received such explanations with skepticism.

In January and February of 1973 Manning and Reeves had also discussed a recent change in the law that had enabled mutual funds to invest in EFCA stock. The extent of such purchases by mutual funds was not as great as Manning and Reeves had both expected it might be.

During February Manning had had an assistant, Karen Calvert, commence monitoring EFCA for daily price fluctuations. A small number of other stocks was similarly monitored.

In the first quarter of 1973 Manning's attitude towards EFCA had become progressively more pessimistic. For about a week to 10 days prior to M & N's liquidation of its clients' positions in EFCA, Manning had considered selling the stock for a variety of reasons, among which its negative price action figured perhaps most prominently.

TZP

Respondent Tomlin, Zimmerman & Parmelee, Inc. ("TZP") has been registered since September, 1972, as an investment adviser under Section 203 of the Investment Advisers Act. Its place of business in March of 1973 was, and is today, in New York, New York.

Donald R. Tomlin and Charles Zimmerman were principals of TZP in March, 1973, as they are today. Tomlin was then a portfolio manager and analyst who followed, among others, the insurance company stocks. Zimmerman then performed general investment work for all of the TZP accounts and was the firm's trader.[11] In the field of analysis of insurance company securities Tomlin had a reputation as a "knowledgeable guy."

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[11] When TZP was incorporated Alfred Parmelee had also been a principal of TZP and was such during the period relevant to this proceeding. However, he had nothing to do with the matters at issue in this proceeding and, by the time of the hearing in this proceeding he had withdrawn from the firm and had sold his interest in TZP to Tomlin and Zimmerman.

In March, 1973, TZP acted as investment adviser for some 11 accounts, which included pension funds, college endowments, and an insurance company. Assets under management totalled approximately $75 million.

Except for the insurance company,[12] which TZP merely advised and which made its own investment decisions, and two pension fund accounts which required oral approval of one trustee before TZP could execute transactions on their behalf, TZP's clients had given it discretionary power to purchase and sell securities for their accounts.

Tomlin and Zimmerman had commenced purchasing EFCA securities for clients in May, 1971, when they were principals of TZP's predecessor. EFCA was added to their "buy" list because research showed that the company was writing profitable life insurance, was increasing its sales at a greater rate than the average life insurance company, was showing greater earnings progress than the average life insurance company, and had come through a difficult period in the market as a continuing strong stock.

Between May, 1971, and March 23, 1973, TZP (and its predecessor) purchased for its clients' accounts some 25,920 shares of EFCA and $60,000 face amount of EFCA convertible debentures.

On March 13, 1973, Tomlin noted in the *Wall Street Journal* a report of a March 12, 1973 press release by EFCA, and on March 20, 1973, he received and read a copy of the release itself. The EFCA press release reported record earnings for 1972 and an increase in life insurance sales. EFCA as a consolidated entity was reported as having sold $2.5 billion of life insurance in 1972, bringing total insurance in force as of December 31, 1972 to $6.5 billion, compared with $4.6 billion at the close of 1971.

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[12] The insurance company did not purchase any EFCA securities.

B. Respondents' Receipt In March, 1973, Of Non Public Information Concerning Fraud At Equity Funding; Contexts In Which The Information Was Received; Responses To Receipt Of The Information; Recognition By Respondents Of The Probable Market Impact Of The Selective Dissemination Of The Information; Involvement, Role, And Activities Of Respondent Dirks.

Respondent III

At about 5:00 p.m. on March 12, 1973, Zukowski at III in Boston received a telephone call from Dirks in New York City. The call lasted 40 to 45 minutes. It concerned a story related to Dirks a few days earlier concerning EFCA by a former employee of EFCA. Dirks did not disclose the identity of the former employee because his informant had told him he feared for his life. Dirks was aware of III's interest in EFCA because of his discussion of EFCA with Zukowski in December of 1972.

The story, if it could be believed, was startling. Dirks said his source had alleged that one-third of the insurance policies carried on the books of EFCA's life insurance subsidiary, EFLIC, during 1969 and 1970 were fictitious. The phony business was known as "Y" business. It was also alleged that EFLIC would sell the phony insurance to other insurance companies through co-insurance or re-insurance arrangements and that it had created fake death certificates to help carry off the scheme. Dirks also stated his source had reported that EFLIC used different names and spellings of policyholders to help dupe the auditors.

Dirks also related that his source had told him that upper-level personnel had been leaving Bankers National, another EFCA subsidiary, in inordinate numbers, and that one had left because of concern over the transfer of a deposit from one bank to another.

Although prodded by Zukowski, Dirks refused to disclose the identity of his source, indicating that the source feared Mafia retaliation at the behest of EFCA. Dirks identified his source as a former employee of EFCA, who, while not in the

accounting department, was in a position to know EFCA's business. In response to a suggestion from Zukowski that the source might be trying to short the stock, Dirks indicated his doubt of that likelihood by remarking that his source appeared to him to be a religious man.

After the conversation had gone on about 10 minutes, Courtney came or was called into Zukowski's room, and, after being filled in on the substance of the conversation to that point, Courtney got on the phone with Zukowski. Meanwhile, at some point fairly early in the conversation, Dirk's associate, Allen Gorrelick, joined the conversation on the New York end of the line.

Dirks further related that his source informed him that EFCA had forged 4 or 5 certificates of deposit during one year in order to inflate assets; that insurance policies of $10,000 were put on the books at $25,000 and then co-insured; and that EFCA gave life insurance policies to employees free of first-year premiums as part of the reinsurance fraud.

Among the additional allegations that Dirks related in that conversation was that EFCA's auditors, Haskins & Sells,[13] had dropped the EFCA account.

Some of the participants in that conversation discussed how or whether it would be possible for fraud of the kind being alleged to remain undetected.

Courtney arranged during the phone call to meet with Dirks in New York on the following day, where he was scheduled to be in any event on other business.

After the phone call, Courtney and Zukowski discussed the matter. Zukowski told him of his high regard for Dirks, whom he had known since about 1966 or 1967. Dirks had supplied Zukowski with research reports and recommendations while the latter had been employed at other firms.

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[13] The record indicates that Haskins & Sells audited EFLIC from 1968 to 1971.

Courtney considered the market at that time to be extremely "nervous" and thought that any kind of negative rumors concerning EFCA could seriously undermine the price of its stock. Indeed, he had cautioned Dirks during the telephone conversation that he could "get into trouble" if he spread about wild rumors about EFCA. Courtney was aware that EFCA had a history of price volatility.

Between 6:00 and 6:30 p.m. (EST) Courtney and Zukowski called Haskins & Sells in California, from whom they learned that that firm had been replaced as EFLIC's auditors by Seidman & Seidman, EFCA's auditors.[14] Haskins & Sells had not "dropped" the account. In response to further inquiry from Courtney, Haskins & Sells' representative indicated they had not heard rumors of fraud at EFLIC.

At about 6:30 or 7:00 that evening Courtney told Wise about Dirk's call and that III was "going to unload" EFCA. Since Courtney was to be in New York the following day, Wise undertook to write up the sell tickets the following morning.

At about 7:00 that evening Courtney called Moore, the trader, at his home to tell him of the decision to sell out III's holdings of EFCA in their clients' accounts and to discuss the mechanics of handling such a large sell order. Courtney indicated he wanted the positions in EFCA sold out even if it required a big discount to do so.

On the following day, Tuesday, March 13, Courtney took a telephone call from Wise at Dirk's office in New York City

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[14] The record indicates that Haskins & Sells audited EFLIC from 1968 through 1971, while EFCA and most of its other subsidiaries were audited through 1970 by Wolfson, Weiner, a local auditing firm, and after that by Seidman & Seidman, which had acquired Wolfson, Weiner. The record also shows that in 1972 Seidman & Seidman also took over the auditing of EFLIC; on the EFCA, EFLIC, and related accounts Seidman & Seidman utilized primarily the personnel that had theretofore been engaged in auditing EFCA and most of its subsidiaries for Wolfson, Weiner.

prior to his meeting with Dirks. Wise advised Courtney that Baker, Murphy, and Fuss would not go along with Courtney's proposed sale of EFCA securities for client accounts that he managed. (Late in 1972 III had instituted a so-called veto system, under which a negative vote by any two or more of the portfolio managers would block a proposed buy or sell order.) Courtney was highly displeased with this response and emphatically directed Wise to work on the other managers to get them to sell.

Courtney then met with Dirks and his associate, Allen Gorrelick. Utilizing his notes, Dirks passed on the following fraud allegations and related representations, among others, concerning EFCA as they had been represented to him by his source:

- One-third of EFCA's insurance business was fake "Y" business which Art Lewis had placed on the books of EFCA;
- $10,000 policies were issued and were shown on the books as $25,000 policies which were then co-insured;
- In order to justify the fake business, fictitious records were created to reflect the deaths of policyholders;
- Insurance policies were given to employees free of premiums in order to overstate EFCA's business;
- Lapsed policies were being co-insured;
- In 1970, one-third of the business was fake;
- The fictitious insurance business was handled according to actuarial tables;
- Micky Sultan, head of electronic data processing, Art Lewis and Jim Smith, the actuary and executive vice president, were very involved in the fake business at EFCA;
- Notwithstanding the supposed increase in business, not enough was being done to sustain the number of salespeople;
- Between December 15 and December 31, the books were falsified by doubling the business;

- Ranger National had reinsured $3 to $6 million of the fake business ($1.7 million in 1971). Eighteen different insurance companies had reinsured the fake "Y" business;
- $5 million of EFCA's assets were fake certificates of deposit;
- Dave Capo and Micky Sultan, EFCA accountants, created the $5 million of fake certificates of deposit which were included in EFCA's assets;
- Six people, including Dirk's source, had left the company within the last thirty days because of pressure put on them to sign false statements and to engage in improper accounting;
- EFCA was attempting to bleed Bankers National, and certain people left Bankers National because they had refused to sign its financial statements;
- The source felt his life was in danger;
- The source had left Bankers National three weeks prior to Courtney's meeting with Dirks on March 13, because he would not go along with the EFCA fraud;
- Stanley Goldblum, Fred Levin and Jim Smith thought like crooks;
- Lyle Fisher and Gene Tibide [*sic*; Thibodeau], employees of EFCA, would talk about what was going on at EFCA;
- Lewis and Edens, EFCA's CPA and life insurance accountants, were creating fake assets by falsifying bank statements;
- The accounting firm of Wolfson, Weiner had shown in EFCA's 1971 convention statement assets of $5 million, which, in fact, were fictitious. This fictitious figure amounted to ten per cent of EFCA's total assets;
- Sol Block of Wolfson, Weiner [EFCA's accountants] was being paid off. His bags were packed and he was ready to go to Rio;
- EFCA would instruct employees as to how to respond to confirmation letters sent by outside accountants who were auditing the insurance business, in order to mis-

lead the accountants; for example, on December 20, 1972, a vice president and treasurer had had statements of the funded loan account sent to his home address;

- When an insurance department examined the insurance policy files, they would be given 50 actual files and the conspirators would create another 50 more to support the false policies;
- Art Lewis of EFCA would produce one of four ledgers depending on who would be seeing them, e.g. outside auditors;
- Haskins & Sells dropped the account because they did not like what was going on at EFCA;
- Although Stanley Goldblum said EFCA was a 15 per cent growth company, the actual rate of growth was not close to that;
- EFCA officers were selling EFCA stock all the time. Stanley Goldblum had been selling for the last six months, as was Fred Levin and Edens;
- A co-insurer had rejected a block of policies submitted through Bankers National, which later had to be replaced with high quality good business. This block had been written by EFCA [EFLIC];
- Art Lewis of EFCA was trying to get names of people at Bankers National who had refused to involve that company in the fraud; and
- EFCA was trying to seize control of Bankers National in order to overstate earnings.

Dirks related that his source had said that the insurance business had always enjoyed a reputation for integrity and that that was the key to the insurance business, and it was for this reason that he wanted to expose what was going on at EFCA. Dirks advised that his source had not previously known Dirks but that "some other guy" had referred him to Dirks as an analyst knowledgeable in the insurance business. Courtney concluded Dirks had spent quite a few hours with his source based on the extensive notes Dirks had taken and which he

referred to in the course of his conversation with Courtney. From the conversation Courtney got the impression that Dirks would be visiting EFCA soon and that there would be other people also who would be hearing the fraud allegations as Dirks had relayed them to him.

Dirks asked whether Courtney wanted to meet Dirks's source, but Courtney declined. The Dirks-Gorrelick-Courtney discussion lasted about an hour and a half.

On the morning of March 13 when Courtney met with Dirks and Gorrelick in New York City, at the III offices in Boston Zukowski and Wise related to Baker, Murphy, Fuss, and Moore the gist of what they knew of the Dirks call of the evening before and of Courtney's desires with respect to the EFCA holdings. Zukowski reported that Dirks's source strongly implied the alleged fraudulent practices were still continuing. Zukowski also reported the check with Haskins & Sells.

As already noted, the proposed sale of EFCA securities in client accounts that Courtney managed was vetoed by Baker, Murphy, and Fuss and Wise had telephoned Courtney that information just before Courtney's meeting with Dirks and Gorrelick.

The vetoes were prompted essentially by the belief on the part of those who vetoed that Courtney was acting precipitiously because in their view, as a minimum, III ought first to do some checking into the matter to determine whether the scheme reported by Dirks was even possible, and, secondly, by their concern, first voiced by Baker, that a check should first be made with III's outside legal counsel for an opinion whether the information received from Dirks constituted inside information such as would preclude their selling on the basis of it without proper prior disclosure.

Regarding the second concern, it was agreed that Murphy should call counsel because he, of those available, had had most contact with III's outside counsel. After the general discussion

among the portfolio managers and others was concluded, Murphy obtained additional details from Zukowski concerning the Dirks call of the prior evening in preparation for talking to counsel. Between 10:00 and 11:00 a.m. Murphy called Donald J. Evans, of Goodwin, Procter & Hoar, III's outside counsel.

In a telephone conversation lasting about 15 minutes, Murphy advised Evans that III had received a call from a broker who had been approached by an unidentified and apparently disgruntled ex-employee of EFCA who had left the firm about 3 years earlier and who had alleged that EFCA's earnings had in the past been inflated by the creation of fictitious or bogus insurance policies that were then reinsured or co-insured by other life insurance companies and that earnings had somehow been transferred among EFCA subsidiaries to boost EFCA's reported earnings. Murphy indicated that the ex-employee had been employed by EFCA in 1969 and that he had left in early 1970, and Evans understood that the allegations of wrongdoing all related to that past period and did not involve continuing wrongdoing. The two of them discussed how the bogus insurance scheme could have been made to work from an accounting standpoint to increase EFCA's reported earnings, and neither of them appeared to have a clear conception of the mechanics of how such a scheme would be feasible or could be successfully carried off. Murphy asked two questions: (1) whether III had an inside-information problem and (2) what steps III could properly take to investigate the rumors. On the basis of the data he had been furnished, Evans orally advised that in his view III was not in possession of material, inside information and that III would be free to investigate or examine all publicly available information regarding EFCA. He specifically cautioned Murphy, however, about not contacting the company, EFCA, either directly *or indirectly*, to seek confirmation or denial of the allegations.

Sometime after the results of this consultation with counsel had been conveyed to other portfolio managers by Murphy, Baker in the afternoon of March 13th called Courtney in New York City to advise him that the vetoes of his proposed sales of

EFCA holdings out of accounts managed by Courtney had been withdrawn. Earlier in the day, but after Courtney's meeting with Dirks and Gorrelick, Zukowski had called Courtney, in view of the uncertainties caused by Wise's "insisting" that Moore, the trader, proceed with Courtney's sell orders notwithstanding the vetoes by three portfolio managers, to advise Courtney that the others were still adhering to their vetoes. In response to each of the two calls, Courtney told first Zukowski and later Baker to hold up on his sell orders and that he would take up the whole matter when he returned to the office the next morning. As he testified at the hearing, Courtney had concluded that he didn't want to impose his will on the others and felt he could better bring them around to his view that all EFCA holdings should be liquidated in a face-to-face meeting.

Early in the afternoon of March 13 Zukowski returned Dirks's call of 9:15 a.m. The call lasted 20 to 30 minutes; Gorrelick was also on the line with Dirks. A number of matters were discussed. Dirks reported that he had had a phone conversation with a Mr. Balint, the "head man" at Haskins & Sells, former auditors of EFLIC. Dirks reported he detected a note of concern in the tone of Balint's responses, though not evidenced in anything specific that was said. Dirks also provided Zukowski with EFCA's 1972 earnings figures. In addition, there was fairly extended discussion among the three of them as to whether it would be possible to carry out the purported scheme without having it all collapse like a typical Ponzi scheme. In addition, Dirks mentioned a particular purportedly forged certificate of deposit (he had mentioned there were 4 or 5 such the day before).

On Wednesday, March 14, at the regular meeting of III portfolio managers, attended by Courtney, Zukowski, Murphy, Baker, Fuss and Moore, Courtney took a few mintues at the outset to summarize his discussion of the previous day in New York City with Dirks and Gorrelick.

After Courtney's brief report Baker, Murphy, and Fuss reaffirmed their previous-day withdrawals of their vetoes of Courtney's proposed sales of EFCA securities out of accounts managed by him. At Baker's suggestion, Courtney as president of III called attorney Evans ostensibly to update him and to recheck the legal advice Murphy had been given. In a short (about 5 minutes) telephone conversation Courtney reviewed his understanding of what Murphy had conveyed to Evans and Evans's advice and guidelines. Evans confirmed that that had been his advice based on the information given by Murphy. Courtney offered the view that he didn't think there was an inside-information problem either. Evans reconfirmed his opinion and advice. This was the last conversation Evans had with anyone at III during the relevant period concerning any rumor of fraud at EFCA.

Courtney had not in fact "updated" Evans on the matter at hand. He did not inform Evans of his extended face-to-face meeting with Dirks and Gorrelick the day before or identify the two. Nor, of course, did he convey to Evans any of the substance of that discussion. Neither was Evans told of the March 13 phone call between Zukowski and Dirks, nor any of its content. Additionally, some of the III personnel had on March 13, after receiving Evans's opinion, commenced "checking" the possibilities that the Dirks story could be true with a variety of sources. The fact of these contacts and their results were not conveyed to Evans by Courtney on March 14th or at any later relevant date by anyone as the "checking" process was continued by III personnel.

On March 14th, at Courtney's direction, Zukowski called Dirks to tell him that Dirks's impending trip to Los Angeles to visit the EFCA offices should not be considered to be on behalf of III and to warn him that in III's view Dirks was risking legal liability by spreading the information. Zukowski also advised Dirks of III's check with counsel Evans.

During the morning of March 14 Courtney urged that III liquidate all of its clients' EFCA holdings. Although Dirks had

not told him that he or his source would be talking to others in the investment community about the alleged fraud, Courtney concluded that since Dirks had talked to III he would be talking to others as well and that Dirks's source was probably also disseminating the allegations. The excess of sellers over buyers and the declining price of EFCA stock during the week of March 12th persuaded Courtney that in this posture any rumors or negative uncertainties regarding EFCA would have a heightened adverse impact on the market for its securities. Courtney was gravely concerned that the stock could drop to $10 or lower, given the circumstances and the volatility it had exhibited in the past. He considered that the existence, and probable dissemination, of the Dirks rumor of fraud at EFCA had killed all chance of a rally.

The other portfolio managers, though they had withdrawn their vetoes of Courtney's proposed sales of EFCA holdings in accounts managed by him, were not ready to liquidate. They wanted to continue the process of checking that they had begun on March 13th; for the most part they still entertained beliefs or at least hopes that EFCA stock would rally.

Late in the day on March 14 Courtney directed Moore to proceed with the sale of the EFCA securities in the accounts he managed. On March 15 III sold into the market 36,500 shares of EFCA stock held in such accounts. The shares were sold through Goldman, Sachs to various other brokers and to their customers for proceeds of approximately $942,795. On March 16 III sold $300,000 face amount of EFCA debentures for client accounts managed by Courtney for proceeds of approximately $260,133.

On March 15 Zukowski submitted a Brokerage Request form recommending that III direct $4,000 to $5,000 in commission business to Dirks's firm, Delafield Childs. The reason set forth on the form was "[i]nsurance company reports and recommendations." A commission of $3,956.20 was generated for Delafield Childs pursuant to Zukowski's recommendation.

On March 15 Moore told the III portfolio managers that a trader at Delafield Childs had told him that he understood that

Dirks had talked to a New York bank about the allegations regarding EFCA. On Friday, March 16, Moore advised some of the III portfolio managers that he had heard via the "trader grapevine" that a large New York City bank had been seeking a buyer for a 100,000 share block of EFCA stock. On Monday, March 19, III learned that a 100,000 share block of EFCA traded that day[15] and that EFCA stock had declined in price in heavy trading.

These developments concerned Zukowski and others at III; they indicated to Zukowski that the Dirks-reported information regarding EFCA was spreading via the traders' grapevine and that that could be "deadly." At Zukowski's suggestion, Courtney emphatically urged Murphy, on some of whose accounts Courtney was co-manager, to dispose of the EFCA holdings in his client accounts.

On March 19 Dirks called Zukowski twice, first at about 2:00 p.m. and later at about 6:00 p.m. In the course of these calls Dirks indicated there might be other people, in California, who were aware of the EFCA fraud story, including the acquaintance of Dirks who had referred Dirks's source to Dirks. Dirks also indicated his source had gone to "a large Eastern authority" with the EFCA fraud allegations. He further told Zukowski he would attempt to get his acquaintance in Los Angeles to speak directly on the phone to people at III. In the later call, Dirks indicated he was altering his earlier plan to go to Los Angeles later in the week, cancelling other business (including travel) engagements, and catching the next available plane to Los Angeles to investigate the EFCA matter further. In the course of the two calls Dirks also indicated he expected to visit the EFCA offices and, either in one of those calls or in a call on the following day, Dirks indicated he had a friend who was a reporter in the San Francisco office of the *Wall Street Journal* and that he would inform the *Wall Street Journal* of the EFCA fraud allegations.

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[15] The sale, by Bankers Trust, actually involved only 99,200 shares.

At the morning meeting at III on March 20, Murphy advised the others that he had decided the previous evening, at home, to sell the EFCA securities held in client accounts managed by him. In reaching that conclusion, one of the factors he considered was his awareness that the Dirks story regarding alleged fraud at EFCA was circulating in the investment community, a fact which would make any EFCA rally very unlikely and further price deterioration in the stock very likely. He was also concerned that if Dirks reported to III information gleaned from a visit to EFCA offices, III might be breaching the "guidelines" established by Evans's legal advice. Murphy recommended that Baker and Fuss also sell out their clients, feeling that a block sale was the only equitable way to do it since so many III clients held EFCA securities. But Baker and Fuss were not yet ready to act, so Murphy deferred implementing his decision until the expected call from Dirks from Los Angeles, and that did not occur until after trading had closed.

Dirks called III from Los Angeles at about 3:00 p.m. (EST) on March 20, having taken a "red-eye" flight to Los Angeles the night before. Dirks advised he had spoken with his acquaintance, later identified as Pat Hopper, and that Hopper was willing to talk to III about the EFCA situation. Zukowski and Baker then talked to Hopper on separate telephone extensions. Hopper said he had left EFCA in 1972. He mentioned Ron Secrist as one of those knowledgeable about the EFCA fraud. In the course of the subsequent conversation it became clear to Baker and Zukowski that Secrist was the man whom Hopper had originally referred to Dirks, i.e. that Secrist was Dirks's original source.

The conversation lasted about 45 minutes. While there were various differences in particulars, the information conveyed by Hopper tended broadly to corroborate what Dirks had said his source, Secrist, had told him. What Hopper related did not in the main purport to be based upon first-hand knowledge, but upon what he had been advised by another or others. He did, however, indicate that he had made his own rough study of

insurance policy sales figures from certain branch offices for 1969 and 1970 and had made calculations which indicated to him that the purported annual EFCA sales of insurance were grossly overstated. Baker and Zukowski asked a number of questions, particularly in the area of how co-insurers or re-insurers could be deceived by EFCA. Hopper's response was that the purportedly-available safeguards in the case they were discussing were not adequate to detect phantom insurance. Hopper further indicated that there was another individual at EFCA who was willing to talk about the EFCA fraud even if it meant his going to jail because of his own involvement. Before the close of the conversation, Dirks indicated that this person, subsequently to be identified as Frank Majerus, was the next individual Dirks would be seeing in the course of his investigation.

After some discussion of the Dirks-Hopper call, Fuss and Baker decided to sell the EFCA securities from client accounts they managed the next day, since, as already noted, trading had closed for the day on the 20th.

Late that evening, March 20, at about 10:00 p.m. (EST), Baker received a telephone call at his home from Dirks. Dirks reported he had been successful in interviewing Majerus, whom he identified as a former comptroller of EFLIC. Dirks recounted the description Majerus had provided about how $4-5 million of fake insurance business at EFLIC worked and how it would show up on the books of EFCA and the report by Majerus that bogus certificates of deposit were deposited in a bank. Dirks also confirmed the identity of Ron Secrist as his original source. Baker then telephoned Fuss at home to tell him, among other things, that Dirks had said he was going to confront EFCA management with the allegations of fraud the next day.

At the morning meeting on the following day, March 21, Baker reported to the other portfolio managers the substance of what he had heard in the second call from Dirks on March 20.

Baker, Murphy, and Fuss all indicated they were in agreement that the time had come to liquidate all remaining EFCA securities held in III client accounts. Accordingly, on March 21, a total of 371,500 shares of EFCA were sold through Goldman, Sachs for total proceeds of $7,117,157. In addition, III sold to Goldman, Sachs $575,000 face amount of convertible EFCA debentures for total proceeds of $436,328. In making these sales III did not disclose its information concerning the allegations of fraud at EFCA nor had it done so at the time of its earlier EFCA sales on March 15 and 16. Indeed, Moore, on March 21, in response to a question from the Goldman, Sachs trader, who had noted heavy trading that morning in EFCA securities, as to whether Moore knew anything about EFCA, replied that he did not. Moore justified this negative reply in his own mind on the grounds that (a) he had no first-hand knowledge of the fraud allegations and (b) ever since the first telephone call from Dirks on March 12, Moore had scrupulously avoided passing on to traders with whom he dealt any of the information that was coming in to III about alleged fraud at EFCA because he realized that such rumors would "spread like wildfire" within the investment community and could cause grave damage to EFCA. In his view, he simply adhered to that policy when the EFCA sales out of III accounts were being effected.

Between the time of Dirks's first phone call to III on March 12 and the sale of all EFCA holdings on March 21, the portfolio managers and Wise did a substantial amount of "checking" in an effort to confirm or disprove the allegations of fraud at EFCA that they were hearing. These checks included telephone conversations with a number of insurance companies that co-insured or re-insured EFCA policies, some insurance companies that were not so involved with EFCA,[16] some calls

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[16] Murphy did not contact any insurance companies, and Courtney declined to participate in any further checking after EFCA securities had been sold out of accounts managed by him.

to broker-dealers and analysts familiar with EFCA, and examination and discussion of EFCA filings available at III including a convention statement filed by Bankers National. A particular focus of the inquiry was to determine whether the kind of fraud being alleged was possible or feasible in light of procedures the co-insurers or re-insurers were following and in light of the other entities that would have to be deceived. The results of these checks were mixed and inconclusive, e.g. one re-insurer reported they had a "foolproof" system whereas another described a somewhat "gentlemanly" arrangement under which Wise concluded deception of the re-insurer was possible. While Zukowski, Baker, and Murphy testified that they felt there was no more than a 5% to 10% likelihood that the reports of significant fraud at EFCA were true, the net result of all the checking done by III was that the allegations being related by Dirks could neither be confirmed nor disproved. Meanwhile, Dirks continued to persist in his investigation during the period, to the point of cancelling other engagements and flying out to Los Angeles to interview other former EFCA employees who might confirm or refute the Secrist allegations. Dirks made some 7-10 phone calls in the period to Zukowski and others at III. From his prior association with Dirks, Zukowski knew that Dirks was persistent and highly motivated—once he "sunk his teeth" into something he stuck with it. During this period, III became increasingly aware that the Dirks story about EFCA was getting around and that it was having a sharply negative impact on the market for EFCA stock. Given Dirks's continuing investigation, things could only get worse in terms of the price impact on EFCA stock, absent a conclusive refutation of the rumors, which in the nature of things wasn't likely in the short term.

Subsequent to the sale of EFCA securities by III on March 21, a number of events occurred that bear on the motivation for and circumstances that prompted such sales.

In a telephone conversation with Dirks on the afternoon of March 21, Zukowski told Dirks that III had sold its EFCA client positions and that III would give him $25,000 in commis-

sion business regardless of how the EFCA matter turned out. Courtney and the other portfolio managers had concurred in the proposal and before year's end III directed over $20,000[17] in commission business to Delafield Childs.

Between March 23 and March 26, III personnel discussed with personnel at Respondent Bristol & Co. the nature of the allegations regarding fraud at EFCA and referred them to Dirks. These circumstances are discussed in greater detail below in connection with the discussion regarding Bristol & Co.'s receipt of information concerning the alleged fraud.

On March 29 Courtney discussed the reasons for III's sale of EFCA securities with William Wolbach, president of TBC and director of III. Courtney reported that III had ". . . received disquieting information from the broker concerning potential adverse developments affecting the company." Courtney also reported that he had checked with Don Evans to make sure they had no "insider information" problems and that the information had come ". . . from a broker who received it from 'a fellow who had been *recently* fired by the company." (emphasis added).

In connection with its receipt of information from Dirks and its subsequent sale of clients' EFCA securities, III used or caused to be used the mails and means and instruments and instrumentalities of transportation and communication in interstate commerce and the facilities of a national securities exchange, i.e., long distance telephone lines during conversations with Dirks and others and with Goldman, Sachs, a member firm of the New York Stock Exchange, through which firm the EFCA securities were sold using the facilities of that Exchange.

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[17] See the finding above respecting prior commission business in the amount of $3,956.20 directed [*sic*] to Delafield Childs after the sales of EFCA from Courtney-managed client accounts.

Bristol & Co.

On March 22, 1973, John Bristol was told by a salesman and longtime friend at Goldman, Sachs that an unspecified affiliate of Bristol & Co. had sold a large block of EFCA stock on March 21. The friend felt impelled to tell him this because he was aware that Bristol was in the process of acquiring more EFCA stock for a client.

Having been unsuccessful in reaching either Wolbach or Garrick of TBC on the afternoon of March 22 and again in the morning of March 23, Bristol called Courtney, having surmised correctly that III was the affiliate that had traded the large EFCA block. Courtney stated III had been informed of allegations of phantom insurance at EFCA and had become concerned about the existence of the reports. After a brief conversation, Courtney suggested Bristol talk to Baker, who could better explain the reasons for III's EFCA sales on March 21st. After the call had been turned over to Baker, he talked briefly to Bristol and thereafter to Lee T. Smith, then Bristol & Co.'s president, whom Bristol regarded as more knowledgeable about insurance companies than he (Bristol) was.

In talking to Smith, Baker identified Dirks as the person who had related the allegations to III and said that Dirks had stated his source was a former employee of EFCA. Baker related to Smith the substance of the Dirks-reported allegations, i.e. co-insurance of phantom insurance policies by EFLIC, fabricated certificates of deposit by EFCA, and manipulation of Bankers National earnings statements.

Baker also advised Smith of the substance of the circumstances surrounding III's having gotten an oral legal opinion and guidelines from Evans, and of the "checking" that III personnel had done thereafter.

On March 23 Bristol and Smith discussed the latter's telephone conversation with Baker. They also discussed a memorandum from Oppenheimer & Co. prepared by Donald Kramer that had been received in the morning mail on that day, which reported that an analyst was reporting accounting irregular-

ities at an EFCA subsidiary and that EFCA management had denied any such irregularities. On the afternoon of March 23 Smith called Kramer, who dismissed as untrue the allegations reported by Dirks. Smith also talked to other insurance analysts in an effort to confirm or refute the fraud allegations. Later that afternoon Bristol and Smith called EFCA's executive vice presidents Yura Arkus-Duntov and Fred Levin in New York City, both of whom denied there was any substance to the phantom-insurance rumors.

About the time that Bristol on the morning of Monday, March 26, was in the process of calling a number of advisory clients to obtain their consents to sell their EFCA holdings, Smith received a telephone call from Baker of III, who suggested to Smith that it would be well for Bristol & Co. personnel to speak directly to Dirks in California, as III personnel had done.[18]

Beginning about 9:25 a.m. on March 26th, Bristol and Smith commenced about a 10-minute phone call to Dirks in California, advising Dirks that they were calling at the suggestion of Baker of III. Dirks reported that he had been talking to various former employees of EFCA out in California over the weekend and that "what he had heard was not good." Bristol testified (R. 4932):

> He said if he were in my position he would sell the stock.
>
> He said the publicity was going to get—going to be bad for the company.

Bristol took this to signify that Dirks was adhering to the information concerning fraud at EFCA that he had previously conveyed to representatives of III. Dirks also mentioned he had been discussing the EFCA allegations with a *Wall Street Journal* reporter, and Bristol formed the impression that the

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[18] Baker had been requested to call Smith or Bristol to make that suggestion in the course of the regular morning meeting of portfolio managers at III on March 26.

WSJ would be coming out with an EFCA story that would be unfavorable. Dirks also stated he doubted trading would continue in EFCA stock until the whole matter had been cleared up because he (Dirks) had talked to the former auditors, Haskins & Sells, and had also prevailed upon the former comptroller of EFCA [Majerus], who had talked to Dirks about the alleged fraud, to talk to Haskins & Sells.[19]

Bristol was concerned about the allegations of fraud at EFCA as reported by Dirks and was concerned about the fact that Dirks "was calling people and telling them negative stories about the stock." Bristol knew that Dirks's selective dissemination of the allegations of fraud at EFCA would have a negative effect upon the market for its stock. Bristol became concerned about liquidating clients' holdings of EFCA as soon as possible.

At about 10:00 a.m. on March 26 Bristol & Co. solicited a bid for 457,000 shares of EFCA common stock from Jay Perry, block trader at Salomon Brothers. Bristol accepted Perry's bid of $17½ (less commissions), representing a discount from the market price of $19.[20]

The 600 shares of EFCA common stock owned by the Bristol & Co. Employees' Profit-Sharing Plan were sold through Clark, Dodge & Co. for a total price of $10,399.[21]

Bristol & Co. solicited and accepted Loeb, Rhoades' bid for the block of its clients' EFCA convertible debentures, totaling $200,000 in face amount, at a net price of $149,000.

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[19] Dirks gave Bristol and Smith the phone number of Michael Balint of Haskins & Sells, but Bristol & Co. did not contact Balint or anyone else at Haskins & Sells because of Bristol's concern about coming into possession of inside information.

[20] Subsequently 200 additional shares were discovered in Bristol & Co.'s clients' portfolios and were included in the block bid for by Salomon Brothers.

[21] Bristol made no effort to sell 600 shares of EFCA common owned by members of his family.

The sale of the 600 shares of EFCA common stock from the Bristol & Co. Employees' Profit-Sharing Plan settled in due course with Clark, Dodge & Co.

The sales of Bristol & Co.'s clients' EFCA common shares and convertible debentures did not settle. Salomon Brothers refused delivery of the 457,200 shares, alleging that the transaction was void for violating the anti-fraud provisions of the securities laws. Salomon and its customer, Lawton-General Corp., sought declaratory relief in the United States District Court. Bristol & Co. denied Salomon's allegations and counter-claimed, seeking damages for breach of contract. The Loeb, Rhoades transaction remained open.

Despite Salomon Brothers' refusal to accept delivery of Bristol & Co. clients' shares, the normal on-balance clearing and settlement procedures of the Stock Clearing Corporation resulted in settlement and delivery of some 20,000 shares reflecting Bristol & Co.'s March 26, 1973 trade. The record discloses several ultimate purchasers, including Lily Levy and Walter Rogers.[22]

In acting to liquidate clients' and the Employees Plan's EFCA holdings, Bristol & Co. failed to disclose the Secrist-Dirks information about alleged fraud at EFCA to Salomon Brothers, Loeb, Rhoades or Clark, Dodge.

While engaged in the foregoing acts and practices, Bristol & Co., directly and indirectly, used the means and instruments and instrumentalities of transportation and communication in interstate commerce, chiefly local and long distance telephone lines (to TBC and III in Boston, Dirks in Los Angeles, among others) and used or caused to be used the facilities of a national securities exchange, namely the New York Stock Exchange, through Salomon Brothers, a member firm.

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[22] Official notice is taken of the on-balance clearing procedure, described at Stock Clearing Corporation Rule 8, N.Y.S.E. Guide (CCH) § 3308.

On March 21, after Dreyfus had purchased the EFCA debentures on behalf of DSIF, Orphanos, as the in-house insurance company expert, was called into the Dreyfus trading room by DiMartino, Dreyfus's trader, to discuss by telephone with Eugene Mercy of Goldman, Sachs the reasons for the trading weakness of EFCA securities. Mercy told Orphanos that Dirks had a negative story[23] on EFCA and that Dirks had several reasons for his negative comments. However, Mercy discounted the Dirks story and reported that he, Mercy, had received assurances from Levin, vice president of EFCA, that EFCA management expected to be in contact with Dirks in Los Angeles and was confident they could correct Dirks's "misimpressions."

Thereafter Orphanos called Dirks by telephone and, finding him not in, left word for Dirks to return his call. Dirks did not call back on the 21st.

Either late on March 21 or on March 22 Quinn learned that DSIF had purchased the EFCA debentures. Quinn told DiMartino he did not believe the debentures were a suitable investment for DSIF in the then market environment. Notwithstanding DiMartino's view that the debentures had so declined in price that they afforded a high yield, it was agreed that the debentures should be sold. Accordingly, before anyone at Dreyfus spoke to Dirks, Dreyfus placed an order with Goldman, Sachs to sell the debentures.

On March 22 Orphanos again called Dirks at Delafield Childs; this time he was given a phone number in Los Angeles

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[23] Mercy said that Dirks had issued a "sell recommendation" and that that was the cause of the stock's weakness. However, there is no other evidence in the record that Dirks issued any formal or informal sell recommendation or that, up to that point, he had advised or suggested to anyone that the stock be sold. However, as found above, Dirks later, on March 26, suggested to John Bristol that EFCA stock be sold.

where Dirks could be reached. In a conversation lasting about 30 minutes, Dirks mentioned nonrecurring gains in EFCA earnings and two or three other matters that might reflect adversely on EFCA's management or its future prospects, but none of which involved reports of bogus insurance or forged certificates of deposit.[24]

On March 23 Quinn took a call from Dirks. Dirks initiated this call to Dreyfus because he had ascertained in the interim through Vicker's publication or somehow that Dreyfus clients had EFCA holdings. Dirks now told Quinn that his source, whom he identified as a former employee of EFCA, reported that EFLIC had put hundreds of millions of dollars of bogus insurance representing tens of thousands of fictitious policies on its books, had fraudulently reinsured the bogus insurance, and had issued phony death certificates as part of the scheme. Dirks also advised Quinn that he had passed on this information to five or six institutional investors. Quinn formed the belief that Dirks believed the reports he conveyed regarding EFCA were true.

Quinn called Orphanos at his home and asked him to follow up with Dirks to get further details, and perhaps more understanding, of the alleged fraud in view of Orphanos's greater expertise respecting insurance companies. Quinn and Orphanos agreed to be in touch again over the weekend prior to Quinn's expected arrival in Los Angeles on other business, at which time he would see Dirks.

Quinn then went into the Dreyfus trading room to ascertain whether the sell order placed the previous day for the debentures had been executed or not. Quinn told Di Martino that he had heard some wild allegations about Equity Funding.

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[24] In the context of this proceeding reports of this kind came to be known as the "soft story" in contrast to the "hard story" reports of widespread fraud involving bogus insurance, forged certificates of deposit, and related details.

DiMartino either was on the direct wire to Goldman, Sachs or picked it up and asked Quinn to relate the information to Mercy of Goldman, Sachs. Mercy told Quinn the debentures had not been sold yet, said the market for EFCA was unsettled, and conveyed the impression that the debentures could be sold only at a deep discount.

Quinn conveyed to Mercy the substance of the fraud allegations respecting EFCA that he had heard from Dirks. He did so because he was perplexed and confused by what he had heard from Dirks, was concerned about his clients' EFCA holdings, and hoped that perhaps Mercy, representing a block trader, could shed some light on the subject.

Mercy dismissed the allegations, indicating he was a personal friend of EFCA's vice president Levin, in whose personal honesty and integrity he had great faith. He said he had been aware of "rumors" regarding EFCA and that that accounted for the low price at which Dreyfus had been able to pick up the EFCA debentures on March 21. Mercy, learning that Quinn intended to be in Los Angeles shortly, urged him to check out the rumors personally with EFCA management.

Quinn decided against selling the debentures at a discount, suspended the sell order, and decided to suspend judgment pending further checking by Dreyfus, including his impending business trip to Los Angeles at which time he would talk in person to Dirks and possibly visit EFCA management.

Shortly thereafter Quinn received a call from Levin, who happened to be in New York City on March 23, and Arkus-Duntov from EFCA's New York office. They stated they understood Quinn had heard some rumors regarding EFCA. Quinn related the substance of what he had heard from Dirks. Levin dismissed the allegations as preposterous and presented arguments to the effect that it would be impossible for such things to occur undetected.

During the afternoon of March 23, Orphanos conversed by phone with Dirks concerning the allegations of fraud at EFCA.

Included in what was conveyed to Orphanos were allegations that one third of all insurance in force at EFLIC was fictitious and that Don Goff, a current employee of EFCA, had confirmed the fraud.

In a subsequent phone conversation the next day, March 24, a Saturday, Orphanos got from Dirks the names and positions of various persons with whom Dirks had spoken in the course of his continuing investigation, including the names and phone numbers of at least four former EFCA or EFLIC employees: Secrist, Hopper, Gene Thibodeau, and Brian Tickler. Dirks also indicated he planned to speak shortly to Michael Balint of Haskins & Sells, EFLIC's former auditors, and that he doubted EFCA would open for trading thereafter.

Over the March 24-25 weekend Orphanos spoke by telephone with Secrist for 44 minutes and more briefly with Thibodeau and Tickler. Secrist talked freely, confirming in general the story as Dirks had given it and adding some particularizing detail. Thibodeau spoke, among other things, of special computer tapes accessible only to top EFCA officers, of "Departments 99 and 65" (code terms for the alleged phony insurance operation), and of 20,000 policies that generated neither bills nor routine correspondence. Tickler showed a reluctance to talk about particulars over the phone but implied that there was a great deal going on at EFCA that wasn't right.

In phone conversations on March 24-25 Orphanos conveyed to Quinn the gist of what he had heard from Secrist, Thibodeau and Tickler, and added his own impression that something was seriously wrong at EFCA. Quinn instructed Orphanos to brief Peter Vlachos, who would be the only Dreyfus portfolio official present at the New York offices on Monday, March 26, empowered to authorize a sale. Orphanos did so. Quinn and Orphanos also arranged on the 25th to speak again on the morning of the 26th, by which time Quinn would have met with Dirks.

Dirks and Quinn met on the evening of March 25 in the latter's hotel room, for about 15 minutes. Dirks carried a satchel of papers, including copious notes of the interviews he

had conducted. He told Quinn that he had contacted additional employees or former employees of EFCA since their last conversation and that they had corroborated information he had gotten earlier. Dirks stated he had begun to fear for his personal safety to the point that he moved to a different hotel after having been advised to be cautious by a representative of EFLIC's former auditors. Dirks indicated to Quinn his understanding that an "unfunded receivables" account was a key element in disguising EFCA's asset shortages.

Dirks reported to Quinn that he had arranged for Majerus and Hopper to meet with William Blundell, a *Wall Street Journal* reporter to whom Dirks had told his EFCA story. Dirks also told Quinn that he had requested Majerus, the former comptroller at EFLIC, to tell his story to a Mr. Balint, the partner in charge at Haskins & Sells, EFLIC's former auditors. Dirks also said he had subsequently learned from Balint that Majerus had called him. Dirks told Quinn that he regarded this as significant because Balint knew Majerus well and that this might prompt Haskins & Sells to "do something".

By the conclusion of his meeting with Dirks, Quinn realized that the story about fraud at EFCA had been "embellished" (i.e. elaborated), and he felt that "the web was spreading." Orphanos, his in-house expert, was crediting the information. Quinn's testimony that he did not believe "totally" in Dirks indicates that at the very least he believed at that point that there was a good chance that the Dirks allegations, as reported by him and "confirmed", in substance, by others, were true.

Early on Monday, March 26, before the market opened, Orphanos and Vlachos called Quinn. Quinn indicated he had seen a large amount of paperwork by Dirks, and that nothing he saw or heard was inconsistent with what Quinn had originally heard from Dirks about fraud at EFCA. Quinn wanted the debenture sell order re-entered. Based on the briefings by Quinn and, earlier, Orphanos, Vlachos concurred and agreed to authorize the sale of the debentures. Having been unable to disprove the allegations of fraud at EFCA after extensive

checking (to the contrary, all the checking results were consistent with and therefore tended to corroborate the allegations), Dreyfus personnel concluded that they should act on the information they had received about fraud at EFCA by selling the debentures. As Orphanos put it (R. 476):

> Sale of the security is . . . if you can't satisfy your doubts completely, is a normal investment conclusion.

Quinn indicated to Vlachos his view that their boss, Howard Stein, then away in Europe, should be advised of the EFCA matter, particularly in light of the EFCA common stock holdings in the DF account.

Shortly after speaking with Quinn, Vlachos reactivated Dreyfus's sell order for DSIF's $500,000 face amount of EFCA convertible debentures without substantive discussion of EFCA with anyone at Goldman, Sachs. Goldman, Sachs, acting as principal, purchased the debentures for net proceeds of approximately $362,933.

In effecting its sale of the EFCA debentures on March 26, 1973, Dreyfus personnel acting on behalf of DSIF used or caused to be used the mails and telephone. The telephone was also used in conversations with Dirks and others and among Dreyfus personnel.

Manning & Napier

On March 21, 1973, Manning telephoned Oppenheimer & Co., a broker-dealer with which Manning & Napier ("M & N") had in the past transacted some business, seeking information concerning EFCA. He first spoke to Neil Weisman, with whom he had had contacts before. Weisman told Manning there was a rumor out concerning EFCA and referred him to Donald Kramer, an insurance analyst and partner at Oppenheimer & Co., who, Weisman indicated, was more knowledgeable about the matter.

Either Weisman or Kramer identified Dirks as the source of the rumor regarding EFCA, and indicated Dirks's employer was Delafield Childs.

Kramer told Manning that the rumor involved questionable accounting practices but that he placed no credence in the rumor. Manning testified that Kramer told him on March 21 that the rumor involved allegations of bogus insurance policies and of a change in accountants at EFCA. The testimony by Manning about having been told of bogus insurance at EFCA is not credited, for a number of reasons. Firstly, in testifying at the hearing Manning exhibited considerable uncertainty as to what was said in his first conversation with Kramer, on March 21, as contrasted with what was said in his second telephone conversation with Kramer, on March 26, after Manning had spoken on the phone with Dirks. Secondly, Kramer testified positively and persuasively that he did not mention on the 21st anything to Manning about bogus or fictitious insurance policies at EFCA and that in fact he had as of that date not heard any such rumor. Thirdly, there is no other evidence establishing that Kramer on the 21st was aware that the rumor regarding EFCA involved bogus insurance. Lastly, in a memorandum dated March 21, 1973, Kramer, in referring to and discounting a rumor regarding EFCA, stated that "— a small brokerage firm following Equity Funding's stock questioned the accounting. Management has denied that there are any accounting changes."

After his conversations with Weisman and Kramer on March 21, Manning attempted to reach Dirks; he was told by Delafield Childs personnel that Dirks was not in but would return the call.

During "pub night" on Friday, March 23, Manning told Reeves that he was "getting out" of Equity Funding.

Dirks did not return Manning's call until the morning of Monday, March 26, when he called from Los Angeles. The call lasted about 35 minutes. Manning indicated to Dirks that they had a position in EFCA and had heard that Dirks had some information regarding EFCA. Dirks told him that EFCA had written bogus insurance policies and that the source of this information was a former EFCA employee who had been in a position to know of the fraud. Dirks also gave Manning the

impression that he was continuing to investigate the allegations. In addition, Dirks reported that top management at EFCA was reportedly involved in the bogus insurance fraud. This is clear from Manning's testimony that during his later call to Kramer, also on March 26, during which Manning was trying to get Kramer's reactions to what Dirks had reported, Kramer expressed the strong conviction that top management at EFCA could not be involved in any such scheme.

Beyond that it is not clear what if any additional information Dirks gave Manning about the fraud at EFCA as he then understood it to be during their 35-minute phone conversation. While it seems likely that Dirks gave additional details in the course of a conversation of that length, given the disposition of Dirks to speak freely about his investigation to anyone he knew had holdings in or "an interest in" EFCA, this is not established by "clear and convincing" evidence and accordingly no finding is made on this point.

On the morning of March 26, after his call to Dirks, Manning called Kramer. In this second conversation, according to Manning, he related to Kramer the gist of what he had learned from Dirks. Kramer adhered to his views that EFCA was all right, and, as noted above, expressed strongly the view that top management at EFCA could not be involved in fraud.

On March 26, directly after Manning had talked to Dirks and then Kramer, M & N liquidated all EFCA securities in its client accounts (5,450 shares of EFCA common stock for net proceeds of $89,952) between noon and 1:00 p.m.

That Manning acted with unusual dispatch in selling EFCA holdings following his two phone conversations is evident from the fact that he had a clerical employee who did not customarily execute securities transactions make the sales rather than awaiting the return at 1:00 p.m. from lunch of his assistant Calvert,[25] who normally executed securities transactions for the firm.

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[25] The two employees had switched their lunch hours that day.

At the time he directed sale of the EFCA stock, Manning was convinced that selective dissemination of the Dirks story regarding EFCA was driving the price of the stock down. (R. 3566). This, in turn, made Manning more disposed to credit the allegations of fraud at EFCA as conveyed by Dirks. In prior sworn testimony given before an SEC investigating attorney on January 25, 1974, Manning testified in part as follows (R. 3559-60):

> I just have to say that if the market conditions were different, possibly if I didn't have the attitude that I did, that I might have ignored him. [Dirks]
>
> * * *
>
> But the stock had come down to the point where I was panicky about it.
>
> It was dropping rapidly.
>
> . . . I was emotional at that time and I was disturbed by the price and confused by what a couple of so-called experts were giving me on both sides of the story.

When the EFCA stock was sold by M & N the information Manning had obtained from Dirks was not communicated to the brokers with whom the sell orders were placed. Nor was there any communication to them of the substance of Manning's conversations with Kramer.

In connection with the sales of its clients' EFCA holdings, M & N used or caused to be used the mails and means and instruments and instrumentalities of transportation and communication in interstate commerce and the facilities of a national securities exchange. M & N used the telephone in seeking and receiving the Dirks information about EFCA and in connection with Manning's conversations with Kramer.

Tomlin, Zimmerman & Parmelee, Inc.

In March, 1973, TZP maintained direct, open telephone lines to a number of broker-dealers with whom it did substantial business, including Goldman, Sachs & Company.

During the week of March 12 Edward Spiegel, a registered representative at Goldman, Sachs, who serviced the TZP account, called Tomlin to advise him that Goldman, Sachs had traded a large block of EFCA stock at a sharp discount. He said he didn't know why, but would attempt to find out. On Friday, March 16, and again on Monday, March 19, Spiegel told Tomlin he had not learned anything.

On March 20 Spiegel called Tomlin and Zimmerman to relate that he had heard "third or fourth hand" that Dirks had a negative story about EFCA. Spiegel did not state the substance of the story, and there is nothing in the record to indicate whether he was aware of it. Thereafter, Zimmerman placed a call to Delafield Childs on March 20th, where he learned from an associate of Dirks, Allen Gorrelick, that Dirks was not in the office but would be calling in.

That same day Dirks returned Zimmerman's call and talked to Tomlin and Zimmerman for about 20 to 30 minutes. Tomlin remained on the phone during the entire conversation and Zimmerman was on the phone for parts of it. In the course of the conversation it became clear that Dirks was calling from California.

During this conversation Dirks indicated that he had questions about a possible change in accounting for dividends to participating policyholders at Bankers National which could have inflated EFCA's 1972 earnings. Dirks also reported that a number of executive employees had left Bankers National recently, to which Tomlin responded that this was well known and was not unexpected when there is an acquisition. The Bankers National convention statement and EFCA's financial statements generally were discussed in this conversation. Tomlin was favorably disposed towards EFCA and attempted to point out positive things about the company.

There was no mention of fictitious insurance or of fraud at EFCA or any of its subsidiaries in the course of this conversation.

Dirks indicated he would be meeting with EFCA management personnel and asked if Tomlin or Zimmerman had any questions they wanted him to explore. One or the other suggested that Dirks attempt to get clarification of the Bankers National "numbers."

Following this conversation and prior to their next conversation with Dirks, on March 22, Tomlin called Don Kramer at Oppenheimer & Co., Edus Warren at Spencer Trask and a Mr. Jones at Edwards & Hanley, and received confirming views that there was nothing wrong with EFCA's accounting and that the stock was a good investment. Prior to March 20, Tomlin had spoken to Edward MacElaney at Conning & Co., who also favored EFCA.

On March 22 Dirks left a message requesting that Tomlin or Zimmerman return his call, which they did at 3:32 p.m. (EST). Tomlin participated during the entire 39-minute conversation that ensued, whereas Zimmerman was intermittently off the phone.

Dirks reported that he had met with EFCA management and discussed the Bankers National convention statement and Bankers National dividends to participating policyholders. Dirks indicated he was not entirely satisfied with management's explanation of the accounting for dividends to participating policyholders nor sure that he could believe their explanations.

Dirks also said that EFCA was issuing insurance policies to employees free of first-year premiums. Dirks testified that this part of the conversation involved policies issued by EFLIC, whereas Tomlin and Zimmerman testified that they understood Bankers National to be the subsidiary involved. Tomlin attempted to explain to Dirks that this would not be an abnormal practice based upon his understanding that it was not uncommon in the insurance industry for companies to offer insurance to their employees at a first-year premium that represented the normal first-year premium less what was paid to salesmen the first year and that, since EFCA had a first-

year commission to salesmen of 100%, that meant there would be no premium charge to the employee in the first year.

There was also discussion during this conversation in general terms of the value of EFCA as a holding. Tomlin referred to a favorable analysis by Conning & Co. and said EFCA's financial statements showed good insurance sales and earnings.

Either during the conversation on the 20th or the 22nd, Dirks indicated he had been talking to a former employee of Bankers National who had been fired, and Zimmerman testified he understood the former employee to be the source of some of the "rumors" Dirks was conveying.

During the March 22 conversation there was no mention of fraud at EFCA or any of its subsidiaries.

By the time the March 22 conversation with Dirks had occurred, Zimmerman had concluded in his own mind that what Dirks had told TZP he was also telling others.

On the morning of March 23 Charles Boillod, a salesman at Goldman, Sachs, telephoned Zimmerman and told him that they were in the process of assembling a sizeable block trade of EFCA and expected to trade about 100,000 shares on an "uptick". Boillod said there was considerable interest in the stock, that they felt its price was bottoming out, and that the projected block trade would pretty much "wash out" the stock, meaning that after a substantial decline in a short period of time in an oversold stock a large trade such as that contemplated could be expected to relieve the selling pressure and afford a favorable environment for a return to higher price levels.

After discussing the call from Boillod, Tomlin and Zimmerman on March 23 purchased 3,000 shares of EFCA at $19¾ as part of a block traded by Goldman, Sachs as agent for both sides. As part of that decision to buy, Tomlin and Zimmerman concluded that the price of the stock was favorable, that the drop in price had been caused in part by the activities of Dirks, and that their conversations with Dirks on March 20 and 22 had

served to correct Dirks's "misimpressions" concerning EFCA, so that they could reasonably expect him not to spread any more negative rumors about the stock.

Later in the day on March 23, a Friday, Dirks left a message for Tomlin or Zimmerman to return his call. Tomlin did not return to the office that Friday afternoon, and Zimmerman chose not to return the call.

On Monday, March 26, prior to 10:00 a.m. (EST), Dirks again phoned TZP from Los Angeles, though his call of the previous Friday had not been returned.

Zimmerman took the call and promptly called Tomlin to the phones as well. A sixteen minute conversation among the three men followed.

Dirks told Tomlin and Zimmerman that his source told him there was fictitious insurance on the books of an EFCA insurance subsidiary. Tomlin and Zimmerman testified that the subsidiary referred to was Bankers National; Dirks's testimony, on the other hand, in its overall context, would have to be taken as referring to EFLIC. It is concluded that while Dirks referred to EFLIC, Tomlin and Zimmerman mistakenly understood the reference to be to Bankers National, perhaps because much of their earlier two discussions had focussed on Bankers National and because Dirks's source for this allegation was identified as a former employee of Bankers National.

Tomlin demanded to know who the source was for this new rumor. Dirks, without identifying him by name, stated that his source was a former employee[25] of Bankers National who had been fired.

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[25] There is evidence in the record that would warrant a conclusion, if the standard of proof being applied were that of "preponderance of the evidence" rather than the "clear and convincing" test, that Dirks identified his sources as former employ*ees* of EFCA. Likewise, there is evidence in the record that would warrant a conclusion, under the less demanding standard of proof, that Dirks told Tomlin and Zimmerman on March 26 not only the allegations of fictitious insurance

Tomlin testified that the amount of reported fictitious insurance was $7,000,000 on the books in 1971. Zimmerman testified to the same figure but was not sure of what year it applied to. Dirks did not refer to a specific figure, but if he had mentioned any figure it would have been about a third of the policies of EFLIC.[27] It is concluded that somehow Tomlin and Zimmerman erroneously came to understand that the amount of fictitious insurance involved was $7,000,000 face amount.

When Tomlin asked Dirks if he believed allegations of fictitious insurance, he stated that "he might." He stated this view even after he had earlier, as he reported to Tomlin and Zimmerman, confronted EFCA's president Goldblum with the allegations of fraud. Goldblum had flatly denied the allegations and had asked whether Dirks was charging that EFCA was committing fraud. Dirks reported that he had stated to Goldblum that he was not alleging fraud.

Dirks also reported in his March 26 conversation that he had reported the allegation of fictitious insurance to Haskins & Sells, EFLIC's former auditors.

Dirks further reported that he had informed EFCA's [and EFLIC's] current auditors, Seidman & Seidman, of the allegation regarding fictitious insurance and had given them a copy of some notes he had taken relative to the matter. Dirks reported that he became very upset when he learned shortly after

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but also in substance the story about fictitious assets and fake death certificates etc., that officers of EFCA were reportedly involved in the fraud, and, in short, the allegations that he, Dirks, was aware of at that time. (R. 1155). Dirks testified that his testimony at p. 1155 of the transcript represented, in substance, his best recollection of what he told TZP on March 26th. (R. 1917). Later, on recross (R. 1929-31) Dirks testified that in certain particulars his testimony as reported at p. 1155 of the transcript was based upon his ". . . hypothesis in trying to figure out what I would have said at that time and not based on recollection, specific recollection." The findings made herein, are only those that meet the "clear and convincing" standard.

[27] See footnote 26 next above.

turning over the notes that Seidman & Seidman had promptly turned over the notes to Goldblum.

Zimmerman testified that some of the time in the conversation on March 26 was spent going over the ground covered in their earlier conversations on March 20 and 22. Tomlin, on the other hand, testified that they did not go over what had previously been covered, nor does Dirks's testimony give any such indication. It is concluded that no significant amount of the March 26 conversation was devoted to reviewing matters covered during the earlier two calls.

Immediately after discussing the implications of their March 26 conversation, Tomlin and Zimmerman decided to sell all EFCA securities held in TZP client accounts.

They were both upset about hearing the fraud allegations from Dirks. Tomlin tended to disbelieve the allegations of fraud and suspected that a bear raid might be in progress. Zimmerman, who had formerly worked at another firm while Dirks was also employed there, felt that Dirks was determined to destroy the stock and that they couldn't tell what kind of a rumor regarding EFCA Dirks would be coming out with next, though he did not attribute any ulterior motives to Dirks's activities.

Tomlin and Zimmerman concluded that Dirks would disseminate the allegation of fictitious insurance to others and that it would get around, and they were concerned about this. They had already concluded that even the "soft story" rumors reported earlier by Dirks had been a factor in depressing the stock of EFCA. They concluded that the further dissemination of the allegations of fictitious insurance at EFCA could only be negative, not positive. They despaired of any hope that the stock would recover—a hope they entertained on the 23rd when they purchased 3,000 additional shares of EFCA. Their concern was heightened by the fact that they were aware that in the past EFCA had reacted strongly to an unfavorable report.

Through March 26 Tomlin and Zimmerman had not heard any report of fictitious insurance at EFCA or any of its subsidiaries from any source other than Dirks.

Prior to the lunch hour on March 26 Zimmerman placed sell orders for all of the EFCA securities held by TZP's clients. These included 26,920 shares of common stock and $60,000 face amount of debentures. 24,500 shares of the stock and all of the debentures were sold through Goldman, Sachs, 200 shares of stock were sold through Stern, Frank and 220 shares through Loeb, Rhoades.

At the time of TZP's sales on March 26, Tomlin and Zimmerman had no knowledge of whether Goldman, Sachs or the other brokers knew of Dirks's report of allegations of fictitious insurance at EFCA.

Before the sale of the EFCA securities held by TZP's clients neither Tomlin nor Zimmerman told any Goldman, Sachs or Stern, Frank or Loeb, Rhoades representative about Dirks's report of allegations of fictitious insurance at EFCA.

After the March 20 and 22 conversations with Dirks, Tomlin had informed Spiegel at Goldman, Sachs of the substance of the conversations; but on March 26 Tomlin made no call to Spiegel, prior to TZP's sales of EFCA securities, even though Spiegel had been the source of TZP's initial information that Dirks had some negative information concerning EFCA.

In connection with the sales of its clients' EFCA holdings, TZP used or caused to be used the mails and means and instruments and instrumentalities of transportation and communication in interstate commerce and the facilities of a national securities exchange.

Raymond L. Dirks

In addition to the findings made above in this part regarding the receipt, investigation, and dissemination of non-public information concerning fraud at Equity Funding by Respondent Raymond L. Dirks in connection with findings made respect-

ing the individual selling respondents,[28] certain additional findings are necessary with respect to Respondent Dirks as bearing on the charges against him.[29]

On March 6, 1973, from "out of the blue" Dirks received a telephone call from Ronald Secrist, who introduced himself as a friend of Patrick Hopper, whom Dirks knew. Secrist further identified himself as a former employee of EFCA or EFLIC and of Bankers National, and said he had some significant information about his former employer that he thought would interest Dirks, e.g. that one-third of EFCA's reported life insurance did not exist, that fake certificates of deposit had been created, and "other sorts of activities that would indicate the Company was doing some mighty unusual things." Dirks agreed to meet with Secrist the next day around noon.

On March 7 Dirks and his associate, Allen Gorrelick, met over lunch with Secrist for about 3½ hours. In substance, the main allegations conveyed by Secrist relevant here were those subsequently reported by Dirks and Gorrelick to III personnel, as found above.

Dirks took extensive notes during the conversation.

Secrist described the origin of the alleged fictitious insurance scheme. He said he understood that when Presidential Life, the predecessor of EFLIC, was acquired Presidential had poor-quality business on its books. Because Fred Levin had managed to reinsure the business at a good price, he was made President of EFLIC. The next year EFCA decided to give its employees insurance without a first-year premium.

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[28] Dirks himself did not sell any EFCA securities; the other respondents are sometimes referred to collectively as the "selling respondents". Dirks is charged with having aided and abetted selling respondents in their alleged violations and with having committed violations independently through his alleged "tipping" activities.

[29] See footnote 28 next above.

This created a large block of insurance that was subsequently reinsured. In 1970, Secrist continued, EFCA at Levin's suggestion embarked on a full-fledged program of totally fictitious insurance in order to sustain EFCA's objectives of 15% compounded growth rate in net earnings. This business, Secrist stated, became the "Y" business, so named by Art Lewis, the EFLIC chief accountant and statistician, because in mathematics "Y" is a symbol for an unknown.

Secrist said he had been told that 1/3 of EFLIC's insurance in force—40,000 policies—was fake and that each of 18 companies with which EFCA reinsured had some of the phony "Y" business.

There was considerable discussion as to how there could be a failure to discover the alleged scheme on the part of the companies reinsuring the fake EFLIC policies. Secrist attributed this to lax procedures on the part of the co-insurers and a tendency to rely too heavily on trust in the insurance industry.

Likewise, there was discussed the question of how the auditors could fail to discover such a scheme. Secrist said that although EFCA had been regularly audited, the audits had not uncovered the alleged fraud. Secrist stated he had been told that the company created fake policy files and that he personally had on one occasion participated in a "party" creating such files. Secrist also stated his understanding that EFCA supplied the auditors with phony confirmation letters from purported policyholders. Secrist exhibited to Dirks and Gorrelick two examples of such confirmation letters, bearing the names of "Crist" and Secret.

Secrist stated he understood that when necessary as many as 20 phony files would be created overnight, after the auditors had indicated what files they wanted to check, and that these would be complete with medical records and other supporting items.

Secrist also reported his understanding that in order to support the fraud it was necessary to create other phony journals, ledgers, and records and that this included the crea-

tion of fictitious bank statements and forged certificates of deposit.

Secrist also told Dirks and Gorrelick he had heard that Sol Block, a C.P.A. with Wolfson, Weiner, the subsidiary of Seidman and Seidman that performed the EFCA [including EFLIC] audits, was actually on the payroll of EFCA and that Block had been "paid off" at the end of 1971.

As to Haskins & Sells, EFLIC's former auditors, Secrist stated he understood that they had been fooled by a number of stratagems employed by Art Lewis and others but that, by the end of the third year of the scheme, they had become very suspicious of EFLIC.

Secrist told Dirks and Gorrelick that he had been told that some people at EFCA had heard of Mafia threats and were inhibited from discussing the fraud.

Secrist told Dirks and Gorrelick that Brian Tickler, a data processing consultant to EFLIC, confirmed the fraud to him. At Dirks's request, Secrist named Lyle Fisher and Gene Thibodeau, who had left the company, as possible further contacts for Dirks. Later in the conversation Secrist gave Dirks additional names of former employees that he said could confirm the fraud and would talk to Dirks: Frank Majerus, Don Goff, Mike Keller, and Pat Hopper.

Secrist also reported that there were stories around the company that the top officers kept a supply of ready cash on hand along with their passports and that they kept their suitcases packed so as to be able to leave the country on a moment's notice "in case this thing blew up."

A considerable part of the conversation involved alleged activities or events or occurrences at or respecting Bankers National, where Secrist had been transferred from EFCA/EFLIC in October, 1971, and to which a number of other EFCA/EFLIC employees had also been transferred. However, those matters are essentially irrelevant to the issues presented in this proceeding. Secrist indicated that while at

Bankers National he had continued to discuss "Y business" and related matters at EFCA/EFLIC with employees at Bankers and others.

The interview included the question of Secrist's motivation in coming to Dirks with his story. Secrist asked Dirks to check the information, verify its accuracy, and then disseminate it as widely and quickly as possible. In response to a question from Dirks as to whether Secrist had sold EFCA stock short, Secrist replied that although a friend had suggested that to him he had rejected the proposal out of hand. Secrist said he felt strongly about the reputation of the insurance industry, which he considered to be basically ethical, and he said he thought fraud of this kind had to be exposed.

Dirks asked Secrist for permission to discuss the EFCA fraud allegations with Herbert Lawson, Chief of the San Francisco Bureau of the *Wall Street Journal*, and Secrist consented.

Secrist indicated he had not gone to the SEC with his allegations about fraud at EFCA because of his understanding that other employees who had done that in this or similar situations had not met with success and had had the confidentiality of their reports breached.

With respect to state departments of insurance, Secrist indicated to Dirks and Gorrelick that Fred Levin of EFCA had formerly worked at the Illinois Insurance Department, that he had heard someone there had been paid off by EFCA, and that, based on what he understood to have been a lack of interest in prior reports of irregularities by others, he had not gone to any state regulatory bodies with his allegations.

After concluding the meeting with Secrist and Gorrelick on the 7th, Dirks left for Philadelphia where he had business appointments and where he remained Thursday and part of Friday, March 8 and 9. Before leaving, he requested Gorrelick to check out with Ron Kehrli, a friend of Gorrelick's who had been with EFCA, the possibility that some confirmation of the

fraud could be obtained, as Secrist had suggested, by examination of the sales records of the 200 most productive EFCA salesmen.

Returning to New York City on Friday the 9th, Dirks obtained from his files the convention statements of Bankers National and EFLIC as well as other reports and the most recent prospectus issued by EFCA. He examined these materials over the weekend of March 10 and 11. He found nothing in them that would tend either to confirm or to disprove Secrist's allegations of fraud at EFCA.

Either on Friday, March 9, or Monday, March 12, Gorrelick, acting on Dirks's instructions, called individuals at Bankers National in an attempt to test the Secrist allegations, particularly as the related to alleged events at Bankers National.

On the morning of March 12, a Monday, Dirks attempted to call Herbert Lawson of the *Wall Street Journal*. Dirks's purpose, as he testified (R. 1249) was as follows:

> Well, I thought that I would try to have somebody who could generate publicity about this investigation it [*sic*]—investigate with me or separately and I wanted to give him the allegations by Mr. Secrist in order that he could do something.

Lawson was not available and it was not until later that Dirks made contact with him.

On the morning of Monday, March 12, Dirks also had a telephone conversation with EFCA's president, Goldblum, using as a pretext for calling the appearance that morning of the EFCA earnings report on the Dow Jones broad tape. The two discussed EFCA's fully diluted earnings, including earnings of EFLIC and Bankers National, which Goldblum reported were up, as well as the number of EFCA's sales agents, but the allegations Dirks had heard from Secrist were not raised. Goldblum invited Dirks to visit EFCA's offices, and they made an appointment for him to do so about March 27-28.

On March 12 Dirks directed his staff to examine Delafield Childs's records to ascertain which clients or potiential clients

"had an interest" in EFCA. "Having an interest" in a stock was something of a euphemism that clients and analysts employed because of a reluctance on the part of clients or potential clients to disclose specifically whether they held a stock or the extent of their holdings. Nevertheless, based on the nature of the contacts, it was frequently possible for an analyst to surmise that a client or contact held or at least likely held a stock and to have some idea of the probable size of any such holding. Based upon examination of the contact sheets and upon Dirks's specific recollection of an earlier conversation with Zukowski of III, III, Institutional Capital, and the Employee Pension and Profit Sharing Plan of Sears Roebuck were identified as likely holders of EFCA securities.

Later in the day on March 12, Dirks called Zukowski and there ensued the 40-45 minute conversation among Dirks and his associate Gorrelick in New York and Zukowski and Courtney of III in Boston, during which the former conveyed to the latter essential elements of the Secrist allegations of fraud at EFCA, as found above.

After his conversation with III officials on March 12, Dirks called Haskins & Sells, EFLIC's former auditors, and spoke with Michael Balint, who had been in charge of the EFLIC account. As Dirks reported to III the following day, he detected a note of concern in Balint's reaction to Dirks's call, as found above.

On Tuesday morning, March 13, Dirks and Gorrelick had their meeting with III's president, Courtney, at the Delafield Childs offices in New York, as found above. Dirks "surmised" that III had a substantial position in EFCA based on Courtney's willingness to visit Dirks and Gorrelick at the Delafield Childs offices.

Additional telephone conversations concerning alleged fraud at EFCA occurred on the afternoon of March 13 and on March 14 between Dirks and Zukowski, as found above.

On the afternoon of March 14, Gorrelick advised Dirks that John Buszin, a security analyst at Bankers Trust Company

specializing in the insurance industry, had told him that Bankers Trust owned EFCA securities, and raised the question with Dirks whether they shouldn't convey to Bankers Trust the same information they had conveyed to III regarding allegations of fraud at EFCA. Dirks concluded they should call Buszin, who confirmed that Bankers Trust held EFCA securities and indicated he would like to hear anything Dirks might have to report about EFCA. Dirks concluded he'd rather convey the information in person and therefore arranged to call at Buszin's offices, only a few blocks away, the following day, March 15.

Dirks met as scheduled with Buszin on March 15, and related briefly the central allegations of fraud at EFCA that he had heard from Secrist. After a time Buszin indicated he didn't care to hear any more and that Bankers Trust was going to sell their EFCA holdings. Dirks was "shocked" to hear Buszin announce that intention so abruptly because in his experience such decisions were normally made much more deliberately.

On Monday, March 19, Dirks called Pat Hopper, a former EFCA employee, after having made a prior unsuccessful attempt to locate him in Los Angeles. Dirks sounded out Hopper about the allegations of fraud at EFCA that he had heard from Secrist. Hopper indicated that while he personally had no evidence of fraud at EFCA, he was inclined to give a certain degree of credence to Secrist's allegations.

While he was on the phone with Hopper, Dirks learned that a block of 100,000 EFCA shares traded that day. In light of Buszin's statements on March 15, Dirks concluded the seller was probably Bankers Trust, and he conveyed that belief to Hopper.

On the 19th Dirks also called Secrist. He told him of his conversation with Hopper. In the course of this conversation Dirks learned for the first time that Secrist had reported his allegations to a state insurance department on the East Coast.

In addition, on March 19 Dirks had two more telephone conversations with Zukowski of III, concerning, among other things, Dirks's impending trip to Los Angeles, as found above.

On March 19 Dirks again called Lawson of the *Wall Street Journal* in San Francisco, Lawson having failed to return Dirks's earlier call. Dirks told Lawson that a former employee of EFCA had alleged that senior officials of EFCA were involved in fraud that included fictitious insurance, death certificates, certificates of deposits and other assets. Lawson responded that the matter might be turned over to their Los Angeles office. (Under established *WSJ* procedures, that "story", as William Blundell of the *Journal* testified, belonged to their Los Angeles office inasmuch as EFCA was located there.) Dirks expected that a highly respected publication like the *Wall Street Journal* could be effective in helping him investigate the Secrist allegations and to expose the EFCA fraud if it proved to exist.

On March 19, rather late in the day, Dirks also called Institutional Capital Corp. in Chicago because a review of Delafield Childs' prior-contact sheets indicated that that firm had manifested an interest in EFCA. Dirks first spoke to Gerald Dhall, a portfolio manager with whom he had had occasion to speak before. Prior to relating any of the Secrest allegations, Dirks first ascertained that Institutional Capital did then own EFCA stock, though the size of the holding was not disclosed. Dirks told Dhall that a former Bankers National employee had told Dirks that EFCA's 1972 earnings were overstated, that EFLIC had been creating fictitious insurance policies and assets, and that EFLIC had been counterfeiting death certificates and certificates of deposit.

At Dhall's request, Dirks repeated the allegations to William Maloney, president of Institutional Capital. Maloney asked what basis Dirks had for relaying these rumors. Dirks replied that he had spoken to two former employees and also indicated he had an appointment to meet with EFCA's president Goldblum in Los Angeles on March 27. Maloney indicated that was

not soon enough, that Dirks could get into a lot of trouble by relaying non-public rumors in this fashion, and that Dirks should fly to the West Coast immediately and confront Goldblum with the allegations. Indeed, Maloney offered to defray Dirks's expenses in going to the West Coast.[30]

After spending much if not most of the day on the 19th on matters relating to the Secrist allegations of fraud at EFCA, Dirks decided abruptly to accelerate his trip to Los Angeles. He took an 11:00 p.m. flight out of New York City and checked into the Beverly Wilshire Hotel in Los Angeles at 2:00 or 3:00 a.m. local time on March 20th. His unscheduled departure meant that Dirks's appointments for the 20th in Hartford, Conn., with three major insurance companies, had to be covered by his associates.

In Los Angeles, on March 20, Dirks met with Hopper from about 9:30 a.m. to approximately 4:30 p.m. Hopper related he had been at EFCA in Los Angeles until August, 1971, at which time he had been sent to Bankers National as vice president for investments. He said he resigned from Bankers National on December 14, 1971, but stayed on until March 10, 1972. He stated he resigned because EFCA officers had wanted him to engage in improper activities, including the use of Bankers National funds as compensating balances for bank loans to EFCA.

The conversation included a discussion of the fact that it was Hopper who suggested that Secrist approach Dirks when Secrist sought advice from Hopper as to how the EFCA fraud could be exposed.

Hopper told Dirks that before leaving EFCA to go to Bankers National, he had heard allegations of fictitious insurance and other fraudulent practices and that later, at Bankers National, he talked with other middle-level executives who had

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[30] As it turned out, Maloney never thereafter offered to pay or share Dirks's expenses, and Dirks never asked for any assistance.

been sent by EFCA to Bankers National, from whom he heard the same allegations emanating from different sources, including Secrist. Hopper told Dirks that these stories tended to confirm one another, even though, as he was frank to say, he had no first-hand knowledge of the alleged fraudulent practices.

Hopper told Dirks that one reason he tended to credit the allegations was a series of conversations he had had with Frank Majerus, whom he regarded as a "nice guy", a very hard worker, very honest, and as a man who was afraid he would be going to jail because of his involvement.

Hopper also told Dirks that he considered Secrist to be honest and sincere, though at times given to hyperbole or to making statements he could not back up. Hopper reported that Secrist had been fired by Bankers National.

Hopper supplied Dirks with substantial detail regarding the alleged fraud at EFCA. At times this differed in particulars from what Dirks had heard from Secrist but its overall effect as an objective matter was clearly to corroborate rather than to refute the Secrist allegations. Nothing that Hopper reported to Dirks contradicted the Secrist allegations in any significant particular.

In the course of the day's discussion, Dirks returned a call from Zukowski of III and put Hopper on the line to talk to III directly, as found above.

Beginning at about 1:30 p.m. on that same day, March 20, Dirks and Hopper met with Frank Majerus, a former comptroller of EFLIC who had also worked briefly at Bankers National and whose reports of fraud at EFCA Hopper had told Dirks he credited.

Most of the approximately 1½ hours of conversation that followed was between Dirks and Majerus. After some initial hesitancy, Majerus freely discussed "Y business" and "special class" business, meaning policies issued to EFCA employees free of first-year premium.

Among other things, Majerus reported that as of the end of 1970 insurance in force at EFLIC was falsely made to rise sharply and that, at Lloyd Edens's request, he and Hopper had prepared false ledgers for earlier portions of the year in order to reflect a purported normal growth pattern for insurance in force. Dirks testified (R. 801) as follows about Majerus's reaction after reporting that information:

> And at that point he sort of dropped his head down and said, "I think I'm going to jail."

Majerus reported he had consulted his minister about the ethical problem he faced and was advised that in view of his family responsibilities he would be justified in remaining with the company until he could find suitable other employment. Majerus reported that Jim Smith and Lloyd Edens had talked him out of resigning at one point but that, nevertheless, after a relatively short stay at Bankers National, he resigned to go with another insurance company.

The details that Majerus provided Dirks, though varying in some particulars, tended to confirm in important respects what Secrist and Hopper had earlier told Dirks. In addition, the greater personal involvement that Majerus conceded and his reports of his personal ethical problems and his fear of going to prison for his involvement, viewed objectively, afforded a significant additional element tending to support the truth of the allegations of fraud at EFCA.

Dirks urged Majerus to contact William Blundell, the Los Angeles Bureau Chief of the *Wall Street Journal*, to tell him what he had conveyed to Dirks. (Blundell had called Dirks on the 20th and made an appointment to meet with Dirks on the 21st after Dirks had on the 20th again called Lawson of the *WSJ* in San Francisco, advising him that he, Dirks, was now in Los Angeles and again seeking Lawson's help with the investigation of EFCA).

On the afternoon of March 20, Dirks, returning a call, spoke with Tomlin and Zimmerman of TZP, and conveyed to them only the so-called "soft story" about EFCA, as found above.

During the evening of March 20 Dirks called Baker of III to inform him of the results of his meeting with Majerus, as found above.

Before retiring for the night on March 20, Dirks, for the first time in his life, pulled up two or three chairs against his hotel room door, because of concern resulting from Secrist's allegations that EFCA employees had in the past been frightened into silence by threats that a Mafia "contract" would be put out on them.

On Wednesday, March 21, a.m. in Los Angeles and p.m. in New York City, Dirks learned in a telephone conversation with Zukowski that III had sold its EFCA holdings in client accounts and that Dirks's firm, Delafield Childs, would be receiving $25,000 in commission business from III, as found above.

On the morning of March 21, following a call from Goldblum suggesting that they get together, Dirks met with Goldblum and Levin at his hotel. Dirks chose to meet at a public place, the hotel's Hideaway Bar, rather than his hotel room, because he was concerned about his personal safety.

Upon meeting, Dirks asked Goldblum how he was. Goldblum replied ". . . not so good. Our stock just dropped four points on a block of 400 and some thousand shares . . ." Dirks responded ". . . my god, that must be the Boston Company . . ." [meaning III].

Dirks told Goldblum and Levin that he had been talking to some former employees who were alleging the existence of fictitious insurance policies at EFCA and briefly described the nature of the allegations. Both categorically denied the allegations, attributed them to disgruntled employees, endeavored to show how legitimate activities might have been misconstrued, and emphasized that it was preposterous to suppose that such a fraud would remain undetected by the cognizant regulatory bodies.

Following the meeting at his hotel, which lasted about a half hour, Dirks accepted Goldblum's invitation to visit the EFCA offices. Dirks spent about three hours there, in Levin's office, where he spoke, among others, with Goldblum, Levin, Edens and Smith. The EFCA personnel discounted and denied each of the several allegations of fraud that were there discussed. Nothing was said in this session that would conclusively prove or rebut the Secrist fraud allegations.

At about 3:30 p.m. on March 21 Dirks kept his appointment with Blundell of the *Wall Street Journal*. The meeting lasted 2 to 2½ hours.

With the aid of his extensive notes, Dirks related to Blundell the substance of all he knew concerning the Secrist allegations of fraud at EFCA. Dirks showed Blundell his notes and described his meetings with Secrist, Hopper, Majerus, and the EFCA officers. Dirks ran through the names of the people Secrist had told him were involved or had knowledge of the fraud.

Dirks gave Blundell the phone numbers of Majerus, Hopper, and Secrist and asked Blundell to help investigate and publicize the allegations.

Shortly after his conversation with Blundell on March 21, Dirks received a call from Walter Delafield, to whom Dirks reported at Delafield Childs. Delafield reported that he had received a call from Jarvis Slade of New York Securities, an EFCA underwriter, complaining that a Bankers Trust analyst was making or relaying allegations of fraud at EFCA and that Slade had indicated he had determined Dirks to be the source of the allegations.

At about 8:00 a.m. on March 22, Dirks received a call from Goldblum. Dirks testified he got the impression Goldblum was trying to feel Dirks out as to what he was going to do. Goldblum said he was on his way to New York City and requested Dirks's permission to tell the New York Stock Exchange that Dirks was not alleging fraud at EFCA. Dirks gave his permission,

saying he had merely related to (unspecified) others the same allegations of former employees that he had reported to EFCA officials the previous day.

Dirks then called Blundell and told him of his conversation with Goldblum. He also asked Blundell whether he was investigating EFCA and the latter responded that he was beginning to make checks.

At about 12:30 p.m., Los Angeles time, on March 22, Dirks spoke with Tomlin and Zimmerman of TZP, as found above.

Later that afternoon Dirks spoke with Orphanos of Dreyfus, as found above.

On March 22 Dirks placed a call to Peter J. "Ron" Ronchetti, a former EFLIC employee, but did not reach him. Later Ronchetti returned the call and they arranged to meet for breakfast the following day, March 23.

On March 22 Dirks also telephoned another former EFCA employee, Gene Thibodeau, whose name Secrist had suggested. Thibodeau was then working in Denver. Their conversation lasted about 20 minutes.

After Dirks inquired about the fictitious insurance allegations, Thibodeau confirmed that he had been employed in EFCA's computer department and said there was substance to the information concerning "Y business". Thibodeau told Dirks he had begun work at EFCA in October 1970 and that he had left a year later because he didn't want to be a part of the fraudulent activity. Thibodeau mentioned "department 99" as the computer code designation for certain fictitious insurance and suggested Ron Ronchetti and Don Goff as persons who might be able and willing to furnish additional data. Thibodeau said he was very glad that Dirks was looking into the matter.

As previously arranged, Dirks and Ronchetti met over breakfast on Friday, March 23, for about an hour.

Ronchetti told Dirks he had been at EFCA in Los Angeles until December, 1971, at which time he was transferred to

Bankers National. He said he remained there until July, 1972, at which time he was fired because he was critical of management.[31]

Ronchetti said he was aware while he was there that EFCA had fictitious insurance on the books in 1970 and 1971 and provided details as to types, what it was called, and reports from a friend as to the numbers of fictitious policies extant as of year end in 1970, 1971, and 1972. He said he had heard of fictitious assets and fake death certificates and that there were death threats.

Ronchetti stated that while employed in EFLIC's computer department he had become convinced that certain blocks of insurance were fictitious, partly because there was a lack of back up materials for certain series of policy numbers.

In response to a question from Dirks as to who might be in a position to supply additional information, Ronchetti mentioned numerous individuals who were either participating in the alleged fraud or who had knowledge of it. Among those mentioned by Ronchetti as persons who might be helpful to Dirks were Brian Tickler, who had left EFCA only four months earlier, and Don Goff, a current employee, whom Ronchetti described to Dirks as knowing as much as or more than anyone. During the course of their discussion Ronchetti telephoned Goff and made a luncheon appointment for the three of them for that day.

After the March 23 breakfast meeting with Ronchetti, Dirks telephoned Brian Tickler in San Francisco. They conversed for about 25 minutes. Tickler confirmed that he had worked for Datair Corporation, a computer service organization that had had a contract to do computer work for EFCA/EFLIC until March, 1972. Tickler said he personally had not worked at EFCA since the end of 1971.

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[31] The record is not clear whether Ronchetti had returned to EFCA at Los Angeles sometime before being fired. See R. 1007, lines 19-21.

After Dirks outlined the Secrist allegations, Tickler responded that he would stake his career on the existence of "Y" business at EFCA and EFLIC in 1970, though he couldn't be sure of 1971. He explained to Dirks the basis for his conclusion that in 1970 there were 10 to 12 thousand fictitious policies extant on the basis of what kept coming out on computer runs even after certain corrections had been made.

Tickler said departments "99" and "96" were special code numbers on the computer tapes designed to cover the phony policies.

Tickler told Dirks that Don Goff was aware of the fraud and that Ron Secrist was very worried and morally concerned about the whole matter.

Tickler also told Dirks that he was ". . . delighted that you're looking into this." (R. 1106).

During the morning of March 23, Los Angeles time, Dirks had telephone conversations concerning the allegations of fraud at EFCA with Quinn of Dreyfus and Zukowski of III, as found above. On the same day Dirks placed a call to TZP intending to report details of what he had heard concerning allegations of insurance fraud at EFLIC, but he was unable to reach either Tomlin or Zimmerman.

Around mid-day on March 23 Ronchetti picked Dirks up, and they met with Goff over lunch for about an hour and a half to two hours. Goff, who was still employed by EFCA, had been a computer systems analyst and supervisor until moving into a "different area" towards the latter part of 1972. Among other things, Goff confirmed the existence of code designations for blocks of fictitious insurance. Goff indicated his understanding that there were 11,000 bogus policies in 1970, 45,000 in 1971, and 55,000 such policies in 1972. These figures were similar to but not identical to those Dirks had heard earlier from Ronchetti. Goff reported that he had heard that an EFCA employee aware of the bogus insurance had "embezzled" $35,000 by turning in 12 such policies to the re-insurers for cash value. Goff stated that he understood EFCA maintained a "mass

marketing" or records-creation group away from its Century City offices, whose function it was to create fictitious backup files and records for the bogus insurance. He said that EFCA utilized a printing plant somewhere to fabricate documents for that purpose.

Dirks concluded that Goff was ". . . very cool, calm and collected . . .", ". . . a fairly credible type of individual", and that ". . . what he was saying was what some of the other people were saying. . . ." R. 1032.

After the luncheon meeting with Goff and Ronchetti, Dirks called Blundell of the *WSJ*. He told Blundell that he had spoken to one present and two former employees of EFCA who tended to substantiate portions of the Secrist allegations. Dirks gave Blundell the names and telephone numbers of Goff, Ronchetti, and Tickler, and related the substance of his conversations with them. Dirks asked whether Blundell would run a story in the *Journal*. Blundell responded noncommittally, but stated that he had reported the Secrist allegations to the Securities and Exchange Commission.

In the afternoon of March 23 Dirks conversed by telephone with Orphanos of Dreyfus, as found above.

On March 23 Dirks returned a call to Fiduciary Trust Company and spoke with Peter Alsop, with whom he had not had occasion to speak before. After Alsop indicated that Fiduciary held substantial EFCA securities, Dirks told him that he had spoken to several former EFCA employees and related to him the substance of their allegations of fraud at EFCA/EFLIC.

Additionally, during the week of March 19, Dirks spoke on several occasions with Dhall or Maloney of Institutional Capital to report the progress of his investigation. In one such conversation Dirks reported his meetings with EFCA personnel and in another he reported that he had spoken to several former employees and one current employee of EFCA and that they tended to confirm portions of the Secrist allegations.

By late afternoon of March 23, after having spoken to one current and six former EFCA employees,[31a] Dirks became concerned about exposing the fraud, if it was a fraud, as soon as possible. He was aware that Seidman & Seidman were planning to release a certified audit statement on Monday, March 26. Dirks believed that if he apprised them of the allegations they would hold up release of their audit report and would seek a trading halt from the New York Stock Exchange pending confirmation or refutation of the allegations.

Dirks called an acquaintance at the Centennial Corporation for guidance as to what top partner at Seidman & Seidman Dirks could talk to in confidence. Dirks then contacted the partner suggested and was told he could "feel very safe" in calling Robert Spencer, Seidman & Seidman's senior Los Angeles partner. Dirks contacted Spencer, who said it sounded like "quite a story." They agreed to meet the next day, a Saturday.

It occurred to Dirks that EFLIC's former auditors should also be apprised. At about 5:00 p.m. on March 23 Dirks called Michael Balint, the partner in charge of Haskins & Sells' Los Angeles office, to whom Dirks had spoken previously about EFCA. After Dirks outlined briefly the fraud information he had received, Balint advised him to leave his hotel immediately for his personal safety and call him back at home in about an hour. Dirks picked up his papers in a hurry and checked into the Beverly Rodeo Hotel under the name of Allen Gorrelick [his associate]. Dirks kept his room at the Beverly Wilshire Hotel, to serve as a place where he could continue to receive messages and, in Dirks's words, ". . . if anybody were coming after me, why, they wouldn't know I had left." (R. 1133.) When Dirks later called Balint at home, they made arrangements to meet for dinner the next night.

[31a] Tickler was not an employee of EFCA or a subsidiary, but as an employee of a contractor doing computer work for EFCA he had opportunity to acquire knowledge of the alleged fraud.

On Saturday, March 24, Dirks met with Spencer of Seidman & Seidman. Dirks related the general substance of the allegations of fraud at EFCA and then allowed Spencer to copy extensive notes he had taken. Spencer assured Dirks they would investigate the situation before releasing their impending certified audit report.

On March 24 Dirks called Orphanos of Dreyfus at home, as found above.

When Dirks met Balint of Haskins & Sells for dinner that evening, the latter rejected Dirks's idea that they dine near his hotel, saying that they had better get out of that area. They therefore drove some 20 miles down the coast to have dinner. They discussed EFCA for about seven hours. Dirks discussed the allegations he had heard in detail.

Balint said Haskins & Sells had been EFLIC's accountants since 1967 and that the firm's last audit of EFLIC was in 1971. Balint stated he knew nothing of the alleged fraud but expressed the view that if top management of the company were in collusion, had perpetrated a fraud, it was conceivable that that could have happened without the auditors' having become aware of it.

After his discussion with Spencer and Balint, Dirks believed it unlikely that EFCA stock would open for trading on Monday, March 26, because he expected trading to be halted by the NYSE.

On Sunday evening, March 24, Dirks met with Quinn of Dreyfus in Los Angeles, as found above.

On Monday, March 26, at about 10:30 a.m., Dirks learned in a telephone conversation with Ronchetti that Goff had learned that Seidman & Seidman had given copies of Dirks's extensive notes to top EFCA management.

As Dirks reported to Blundell of the *WSJ*, this little bit of intelligence caused him to run out of his hotel room in a "state of panic". Dirks asked whether Blundell could do something about publishing the allegations.

Later in the day, at about 3:00 p.m., Dirks again spoke to Blundell and asked if he was prepared to publish the story. Blundell indicated he was meeting shortly with three representatives of the SEC's Los Angeles Regional Office and got Dirks's permission for Blundell to ask whether the SEC wanted to meet with Dirks, Hopper, and Majerus.

Later in the day Blundell called Dirks to report that the SEC officials would like to meet with Dirks, Hopper, and Majerus.

Several hours after that, Dirks and Hopper met with Blundell for several hours to discuss further the allegations of fraud at EFCA.

That evening, Dirks and Hopper contacted Gerald Boltz, the Commission's Regional Administrator in Los Angeles, and made arrangements to appear at the SEC's offices at 9:00 a.m. the following morning.

Apart from the foregoing, Dirks had a number of other contacts on March 26 concerning the allegations of fraud at EFCA. The order in which they are referred to here is not necessarily in chronological sequence.

On March 26 Dirks spoke with Bristol of Bristol & Co., Tomlin and Zimmerman of TZP, and Manning of Manning & Napier, all as found above.

On March 26 Dirks also related to personnel at the Savings and Profit Sharing Trust of Sears Employees the allegations of fraud at EFCA, including information regarding bogus policies, "Y" business, etc.

On the same date he called Fidelity Management and Research in Boston, but he did not relate the fraud allegations to them, because he learned they did not own EFCA stock.

On March 26 Dirks also returned a call to Lawton General, an investment subsidiary of Loews Corporation. Dirks spoke to Wallace Bowman, whom he understood to be in charge of Loews' investment portfolio. Dirks was aware at the time that Lawton had that morning purchased a substantial block of

EFCA. Bowman said he'd heard that Dirks had a story about EFCA. Dirks replied that he assumed the stock Loews had purchased that morning was stock Bristol & Co. had sold, and that he'd give Bowman the same information he'd given Bristol. Dirks then gave Bowman the full story about allegations of fraud at EFCA as he understood them, and also put Hopper, who was with him at the time, on the line to talk to Bowman.

On the evening of March 26 Dirks received a call from Harold Richards of Fidelity Corporation of Virginia. Richards said Fidelity was the largest EFCA stockholder and said he'd heard Dirks was doing some analysis of EFCA. Dirks told Richards he'd been talking to some former employees and one current EFCA employee and that they had made allegations of fraud. Richards interjected and said he had a tape recorder running, to which Dirks responded that he had no objection. Dirks also urged Richards to come out to Los Angeles personally, but Richards demurred, saying he did not fly. Dirks gave Richards a pretty complete recitation of the allegations, as he had given Loews.

On March 26 or early March 27, Dirks related the allegations of fraud at EFCA to Steinhardt, Fine and Berkowitz. Early on March 27 Dirks conveyed briefly to an analyst at Morgan Guaranty the allegations of fraud at EFCA after learning that Morgan Guaranty had an interest in EFCA.

On March 27, sometime before 8:30 a.m., Los Angeles time, Dirks placed a call to an insurance analyst at the Ford Foundation. Unable to reach him, Dirks spoke instead to the head of research. Dirks did not recall the length of the conversation or the extent to which he went into the allegations of fraud at EFCA.

On March 27, at 12:45 p.m., (E.S.T.), trading in EFCA securities was halted by the NYSE. The following day, March 28, the SEC suspended trading in EFCA, securities.

In the course of Dirks's investigation into the allegations of fraud at EFCA and his selective dissemination of the allegations he heard to the selling respondents and to others, Dirks

directly and indirectly used and caused to be used the mails and means and instruments and instrumentalities of transportation in interstate commerce, i.e. travel between New York and California and local and long distance telephone lines. In addition, in the course of such investigation and dissemination, Dirks, as is brought out more directly in other portions of this decision, directly or indirectly caused others to use, or aided and abetted their use of, the facilities of the New York Stock Exchange in liquidating EFCA holdings of their clients.

C. Elements Of The Charged Violations; Respondents' Contentions.

Trading by a corporate or other insider or his tippee on the basis of material inside information not publicly known and not properly disclosed is well established as a violation of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.[32]

Section 17(a) and Rule 10b-5 provide, respectively, as follows:

> **FRAUDULENT INTERSTATE TRANSACTIONS**
>
> Section 17. (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

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[32] E.g. *Cady, Roberts & Co.*, 40 S.F. C. 907 (1961); *S.E.C.* v. *Texas Gulf Sulphur Co.*, 401 F. 2d 833 (2d Cir. 1968) (Rule 10b-5); *Investors Management & Co. Inc., et al.*, 44 S.E.C. 633 (1971).

Rule 10b-5. Employment of Manipulative and Deceptive Devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

The three numbered clauses of Section 17 and Rule 10b-5 have been held to be mutually supportive rather than mutually exclusive. Thus, a breach of the duty of disclosure may be viewed as a device or scheme, an implied misrepresentation, and an act or practice, violative of all three clauses. However, a finding of violation of a particular clause, e.g. clause (3), renders it unnecessary to consider whether the other two clauses have also been violated.[33]

Non-public information

The record herein establishes beyond serious challenge that the information regarding allegations of fraud at EFCA received by the individual selling respondents was non-public at the times they received it and at all times up to the times they sold or attempted to sell their clients' EFCA securities.

No published report of allegations of fraud at EFCA available generally to the investing public appeared until publication on April 2, 1973 of Blundell's Pulitzer-nominated article in the *Wall Street Journal*. The Dow Jones Broad Tape, *after* the

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[33] *Cady, Roberts & Co.*, 40 S.E.C. 907, 913 (1961).

close of trading on March 26, reported that heavy trading in EFCA had been accompanied by rumors concerning EFLIC, which rumors were reported as centering ". . . on the accuracy of the subsidiary's reported statements of new policies written and total insurance in force." The report contained no attribution of source or indication of magnitude or details of the problem. The gist of this report was published the next day in the *Wall Street Journal*, again without the details that would be necessary to make the information equivalent or comparable to that received by the selling respondents.

Even incident to or following the halting of trading in EFCA stock by the New York Stock Exchange on March 27 and the suspension of trading on March 28 by the Commission there was no publicly available report concerning fraud at EFCA analogous to the information received earlier by the selling respondents until the mentioned *Wall Street Journal* article of April 2.

Information derived from inside sources

Secrist and five other ex-employees of EFCA[32a] and one current employee (Goff) of EFCA, from whom Dirks obtained information respecting allegations of fraud at EFCA in the course of his investigation, were clearly "inside sources" since they were reporting information that had come to their attention while they were employees of EFCA or an affiliate. Jacobs, *The Impact of Rule 10b-5* (1974) § 66.02[a], at p. 3-275, note 46. These employees did not have to be officers (although most were in fact second-level managers or officers), directors, or controlling shareholders. *Ross* v. *Licht*, 263 F. Supp. 395, 409 (S.D.N.Y. 1967); *S.E.C.* v. *Texas Gulf Sulphur*, 258 F. Supp. 262, 279 (S.D.N.Y. 1966), *affirmed in part*, 401 F. 2d 833 (2d Cir. 1968).

The law is well settled that selling respondents as "tippees," even though they received their inside information wholly or in

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[32a] See footnote 31a above.

large part through an intermediary (Dirks), became subject to the same disclosure requirements as governed the insider "tippers", i.e. EFCA employees and ex-employees having information concerning the alleged fraud at EFCA. One who knows himself to be a beneficiary of non-public, selectively disclosed inside information must fully disclose or refrain from trading. *S.E.C.* v. *Texas Gulf Sulphur Co.*, 401 F. 2d 833, 848 (2d Cir. 1968) (en banc), *cert. den.* 394 U.S. 976 (1969); *Shapiro* v. *Merrill Lynch*, 353 F. Supp. 264, 276, 279 (S.D.N.Y. 1972); *Faberge*, Securities Exchange Act Release No. 10174 (May 25, 1973) [1973 Decisions] Fed. Sec. L. Rep. (CCH) ¶ 79, 378, p. 83,105; *Investors Management Co., Inc. et al*, 44 S.E.C. 633, 639-41 (1971); *Merrill Lynch, Pierce, Fenner & Smith*, 43 S.E.C. 933, 936 (1968).

Materiality of the inside information

Materiality is a mixed question of fact and law, involving as it does the application of a legal standard to a particular set of facts.[34] The circumstances under which each selling respondent received non-public, inside information, as found herein, were different, and the question of materiality must be determined individually for each selling respondent on the basis of the facts applicable to it.

The criteria or tests for determining materiality elucidated by the courts tend to take on colorations stemming from the particular facts involved, which makes discernment of a single, all-encompassing test of materiality difficult at best. One writer perceives three categories of tests:

> The courts have not settled on a single objective test to determine whether a fact is material. Three categories of tests can be discerned: One dealing with the judgment of a reasonable investor or reasonable stockholder, another

[34] *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 450 (1976).

> weighing the probability that an event will occur against its indicated magnitude, and a third concentrating on the market impact of a disclosure.[35]

The first basic test referred to by Jacobs, as relevant to the instant proceeding, may be stated as follows: Would a reasonable investor consider the information important in deciding whether to purchase, sell, or hold.[36] This test is stated in terms of "would" rather than "might" in view of the Supreme Court's decision in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976), involving a proxy solicitation under Rule 14a-9 issued under the Securities Exchange Act, where the Court, at p. 449, held, after discussing the "would" vs. "might" split among the circuits:

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. [emphasis supplied] [*sic*]

Prior lower court and Commission decisions respecting tests of materiality, including those cited above, must be read as having had their "thresholds" raised from the "might" to the "would" level wherever necessary. See, e.g., *SEC* v. *Bausch & Lomb Inc.*, 565 F.2d 8, 14-15 (2d Cir. 1977).

Another basic test of materiality from the third category referred to by Jacobs, as relevant here, may be stated as follows: Would disclosure of the inside information, in reason-

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[35] Jacobs, *The Impact of Rule 10b-5* (1974), § 61.02[b], pp. 3-74, 3-75.

[36] *SEC* v. *Shapiro*, 494 F.2d 1301, 1305 (2d Cir. 1974); *Radiation Dynamics* v. *Goldmuntz*, 464 F. 2d 876, 887-88 (2d Cir. 1972); *SEC* v. *Texas Gulf Sulphur*, 401 F. 2d 833, 849 (2d Cir. 1968), *cert. denied sub nom. Coates & Kline* v. *SEC*, 394 U.S. 976 (1969); *List* v. *Fashion Park*, 340 F. 2d 457, 462 (2d Cir. 1965); *cert. denied sub nom. List* v. *Lerner*, 382 U.S. 811 (1965); *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith*, 353 F. Supp. 264, 272 (S.D.N.Y. 1972); *Investors Management Co. Inc., et al.*, 44 S.E.C. 633, 642 (1971).

able and objective contemplation, have a substantial impact on the market price of the securities involved.[37]

These two standards for determining materiality, i.e. the effect of inside information on a reasonable investor's judgment and the impact of disclosure of the information on the market price of the involved security (Jacobs' categories one and three) are very similar and in all but a few situations overlap and coincide. Thus, information that would influence reasonable investors would cause a sufficient number of them to buy or sell (depending upon whether the information were favorable or unfavorable) to substantially affect the market price of the security. Likewise, inside information that would in the judgment of a reasonable investor substantially affect the market price of a security by causing a sufficient number of other investors to buy and sell would prompt him to buy or sell in anticipation of the expected market impact. While the U.S. Supreme Court has not in terms adopted the market-impact test, it is clear that the first test, which it does employ, is broad enough to encompass the market-impact test as well.[38]

A third basic test of materiality, listed by Jacobs as his second category and described by him in shorthand terminology as the "probability yardstick,"[39] comes into play only when the inside information involves an element of contingency or uncertainty as to the occurrence or existence of the event or condition that is the subject of the inside information, e.g. test bores that may or may not foretell a large mineral discovery,

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[37] *SEC* v. *Texas Gulf Sulphur, supra*, 401 F.2d at 849-50; *List* v. *Fashion Park, supra*, 340 F.2d at 462; *Kohler* v. *Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963); *Investors Management Co., Inc., et al.*, 44 S.E.C. 633, 642 (1971); *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 937 (1968). Jacobs, *The Impact of Rule 10b-5*, § 61.02[b] pp. 3-81, 3-82 (1974).

[38] Jacobs, *supra*, § 61.02[b], pp. 3-83, 3-84.

[39] Jacobs, *supra* , § 61.02[b], pp. 3-75, 3-81.

negotiations that may or may not result in a merger, acquisition, or large contract, and the like. Where these elements of contingency or uncertainty exist, the test holds that probability must be weighed against the magnitude of the impact the information would have on the inherent value or prospects of the company or on the market price of its securities. The greater the potential impact, the smaller is the degree of likelihood or probability that needs to be present to make the information material.[40] This is but a reflection of how the objective, reasonable investor would be expected to respond to such circumstances, and is a corrolary [*sic*] of the other two basic tests.[41]

Since the allegations of fraud at EFCA were not admitted or otherwise clearly established prior to the times of the alleged violations by the selling respondents,[42] it is clear that the probability vs. significance basic test, along with the

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[40] *SEC* v. *Texas Gulf Sulphur*, 401 F.2d 833, 849 (2d Cir. 1968) (preliminary drilling results found material); *Investors Management Co., Inc., et al.*, 44 S.E.C. 633, 642 (1971) (adverse earnings *projections*, among other items); *SEC* v. *Shapiro*, 494 F.2d 1301, 1305-07 (2d Cir. 1974) (possible, though not probable, merger that would increase earnings 600%); Jacobs, *supra*, § 61.02[b] p. 3-81.

[41] Jacobs, *supra*, § 61.02[b] p. 3-81.

[42] The record establishes that the basic allegations of massive insurance fraud at EFCA were in fact true and that such operations were but part of an even larger fraud that precipitated EFCA into bankrutpcy [*sic*] under a petition filed April 5, 1973, under Chapter X of the Bankruptcy Act. On or about April 10, 1973, the Court appointed a Trustee for EFCA, which was ultimately reorganized and is now doing business as Orion Capital Corporation. In his report of October 31, 1974 (Div. Exh. 1), the Trustee reported that the insurance phase of the fraud was another means by which EFCA inflated its reported earnings. This involved generating fictitious premium and re-insurance income on EFLIC's books. Bogus insurance known to the conspirators as "Y business" and segregated on

reasonable-investor and market-impact[43] tests, needs to be employed in determining the issue of materiality. Under the facts presented by this record the three tests overlap considerably and will perforce at times be considered together.

Lastly, courts have at times employed a subjective test of materiality by looking to what individual recipients did in response to the receipt of inside information.[44] The better analysis is to view these uses of subjective indicia merely as applications of the reasonable investor test. That is, a court, or the Commission, having concluded that the recipient of inside

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EFCA's computers as "Department 99" was responsible for $5.5 million in non-existent premium income in 1970, and the figures for 1971 and 1972 were estimated at "up to $10 million" and "at least $14.67 million," respectively. The record establishes that Goldblum, Levin, and numerous other EFCA-EFLIC employees were involved in the fraud, as well as three accountants of the Wolfson, Weiner firm.

[43] The market-impact test discussed above is not to be confused with the so-called market information theory of liability. Market information has been defined as "information which emanates from non-corporate sources . . . primarily . . . concerning or affecting the trading markets for a corporation's security." *Oppenheimer & Co.*, [1975-76 Transfer Binder] Fed . Sec. L. Rep. (CCH) ¶ 80,551 at 86,415 n. 2 (Exchange Act Rel. No. 12319, April 2, 1976). In the instant proceeding knowledge of various selling respondents that Dirks as tippee was in turn selectively disseminating (tipping) the material inside information to others was inextricably interwoven with communication of the inside information itself to the selling respondents. Such knowledge was part of the totality of circumstances under which the selling respondents received the inside information. It therefore had a bearing on application of all three of the basic tests of materiality and should not be viewed as market information as if such had been received in isolation.

[44] *SEC* v. *Shapiro*, 494 F.2d 1301, 1307 (2d Cir. 1974); *SEC* v. *Texas Gulf Sulphur*, *supra*, 401 F.2d at 851; *Cady, Roberts & Co.*, 40 S.E.C. 907, 911-12 (1961); Jacobs, *supra*, § 61.02[c], pp. 3-86 *et seq.*

information was under the circumstances in the position of a "reasonable investor," looks to his response to and use of the information as an indication of whether a reasonable investor under an objective standard would regard the information as material. This analysis retains the objective character of the basic tests of materiality. It should be noted in this connection that there is generally, or at least frequently, another reason for inquiring into a recipient's or holder's response to the receipt or possession of inside information, i.e. to establish whether he acted on the basis thereof or on the basis of some independent and unrelated cause.

In this proceeding most selling respondents contend they acted on the basis of independent motivations and considerations, and findings on those assertions are of course required. Depending upon their nature, such findings may also be relevant on the issue of materiality, and they are therefore treated under this issue.

In *Investors Management*[45] the Commission looked among other indicia of materiality, to the degree of specificity of the inside information, the extent to which it differed from information previously disseminated about the company, and its general reliability in light of its nature and source and the totality of the circumstances in which the information was received. These indicators are pertinent here.

Although each selling respondent received the inside information concerning allegations of fraud at EFCA in varying detail and in varying degrees of specificity, it is clear from the findings herein that each of them received information that clearly met the requirements of specificity. As a minimum, the allegation received was that there was bogus or phantom insurance in a substantial amount at a subsidiary of EFCA either presently or during a fairly recent period with a good possibility that some fraudulent insurance was still on the books. Most

[45] *Supra*, 44 S.E.C. at p. 642.

selling respondents heard a good bit more in terms of specificity, including code names for the bogus insurance, alleged involvement of management personnel, use of the computer in the alleged scheme, amounts of phony insurance in terms of percentage of policies or number of policies, fabricated and falsified records to carry out the alleged scheme, creation of phony certificates of deposit and other assets, etc. Respondents do not much question the specificity of the allegations; they strongly contest the believability of the allegations, an element considered at a later point herein.

The allegations of fraud at EFCA were unlike anything that EFCA had either publicly or within the investment community ever been charged with before. Although some elements of the generally-conservative insurance industry and some elements of the investment community considered EFCA to have a "soft shoe" image and a reputation for favoring "liberal" accounting practices, none of that began to approach the specific allegations of widespread insurance fraud that are involve here. In no sense could these fraud allegations be put into a "so-what-else-is-new" category. While there had been vague rumors in the past concerning EFCA's accounting practices or similar matters, they bore no semblance to the specific, startling allegations here involved.

Respondents strongly contend the fraud allegations were inherently incredible and that they were unbelievable because they came from an unreliable source, a disgruntled, fired employee.

Respondents' arguments respecting the reliability and believability of the fraud allegations overlook a number of significant factors.

Firstly, fired or disgruntled employees, although they may inveigh against their former employers, are not likely to risk their professional reputations by bringing serious fraud charges against them of a nature that, when disproved, would be bound to bring industry-wide discredit upon the accuser. Secrist came to Dirks for help in exposing what he considered a

fraud at EFCA, not to damage EFCA in some surreptitious way that would forever protect his own identity as the informer. Dirks later learned that Secrist had also taken his allegations to an Eastern regulatory agency [the New York State Insurance authorities] and Dirks advised some of the selling respondents of that fact. Although Secrist at first asked Dirks to keep his identity secret, it became clear as events unfolded that Secrist was willing to speak to a number of people, including a representative of at least one selling respondent, in order to help expose the fraud, even at the risk of disclosing his identity. As Dirks's investigation progressed, Secrist was increasingly willing to let his identity become known.

Moreover, Secrist was not the only source of the fraud allegations. By the time Dirks conveyed the inside information to the last of the selling respondents he had talked to one current EFCA employee and six former employees.[45a] By the time Dirks completed his contacts with III, the first of the selling respondents to liquidate its clients' EFCA holdings, Dirks had talked to two other ex-EFCA employees: (a) Hopper (indeed, Hopper personally talked by phone with III) and (b) Majerus. As Secrist's allegations found support from additional ex-employees of EFCA and one current employee, the reliability of Secrist and each of the others as a source became enhanced and strengthened. Surely a reasonable investor would not suppose that they were all demented or misconstruing innocent facts and circumstances as a basis for serious fraud charges at the risk of their professional reputations.

This is not to say that these sources "established" or "proved" the fraud charges; but certainly they raised the likelihood that the charges had some validity to a level that would cause a reasonable investor to want to consider and weigh such

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[45a] See footnote 31a above.

information as a part of the "total mix" of information available to him about EFCA before making an investment decision.[46]

Moreover, the fact that Dirks, an experienced insurance company analyst, was investigating the Secrist allegations and reporting his results to, among others, the selling respondents, is a fact that in itself, in the circumstances found herein, served to enhance substantially the believability and reliability of the particular fraud information received by each of the selling respondents.

While Dirks testified at the hearing in this proceeding that he did not believe the fraud allegations, his dogged determination and persistence in pursuing his private investigation into the allegations and his systematic program of selectively disclosing the results of his investigation to large institutions that held EFCA securities or "had an interest" unmistakeably [*sic*] belie his testimony.

Dirks's personal belief as to the likelihood that the fraud allegations were true is relevant at this point of the discussion because his belief must necessarily have reflected itself in the tone and in the conviction, or lack of it, with which Dirks communicated the fraud information to each of the selling respondents.

Dirks's early and growing belief that the fraud allegations regarding EFCA were to a significant extent more probably true than not true is evident from a large number of facts and circumstances.

Secrist approached Dirks with the allegations in the hope and expectation that Dirks would help expose the fraud by jogging the market for EFCA securities through dissemination of the information. As the findings herein show, Dirks promptly embarked on a course of selective dissemination of

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[46] *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976).

the allegations that had precisely that effect. Even after Dirks became aware that his "tips" had prompted specific sales of EFCA securities in substantial amounts that were quite clearly adversely affecting the price of EFCA securities, he knowingly continued his program of selective dissemination to anyone who owned EFCA stock or "had an interest" in EFCA. My assessment of Dirks, formed during the extended periods of his testimony in this proceeding and on the basis of the entire record, is that he is not not [*sic*] a person who would in mean or reckless fashion have embarked upon and continued a course of conduct so clearly harmful to EFCA on a mere possibility that the charges were true and in order to "smoke out the truth" at such damage to EFCA. My assessment is that he would only have done so under a belief that the allegations, or a substantial portion thereof, were more probably true than not. This is particularly the case in light of Dirks's having previously met and known Goldblum and other officers of EFCA.

In connection with Dirks's rather extended campaign of selective dissemination of the fraud allegations, the findings show that Dirks made this his major, and for over a week virtually his sole, concern. In a couple of cases he put Hopper on the line to talk directly to his tippees. In a number of cases he gave tippees the names and phone numbers of his informants, so that tippees would be free to make their own contacts if they desired. These actions by Dirks, under all the circumstances, indicate not a "neutral" posture on his part but that he was endeavoring to persuade the tippees that there was substance to the fraud allegations.

The findings herein also show that concurrently with his selective disclosures of the fraud allegations, Dirks repeatedly prompted a *Wall Street Journal* reporter to come out with a story on the allegations. Again, it is my judgment of Dirks that he is not a person so base or reckless as to have urged this course absent a belief that the allegations were more probably true than not. This conclusion is based not only upon an evaluation of his character in terms of willingness to harm EFCA but upon an [*sic*] a judgment that he was concerned enough about

his own self interest not to have wanted to jeopardize his credibility and reputation both with the *Wall Street Journal* and with the investment community in which he worked by spreading serious fraud allegations absent a belief on his part that the allegations were more probably true than not.

What Dirks heard as his investigation progressed tended to confirm rather than to disprove Secrist's allegations, even though there were some peripheral contradictions or anomalies. At no time did Dirks tell any tippee that he disbelieved the allegations, even though he might have characterized the allegations as "incredible." In the total contexts in which Dirks used the term, it is clear that he was employing "incredible" in the sense of "extraordinary" or "bizarre." As found herein, Dirks specifically told one tippee, John Bristol, that if he were in Bristol's position he would sell the EFCA holdings. Dirks's contemporaneous reports of fears for his personal safety also say much about the state of his belief.

Dirks's personal belief as to the reliability or believability of the fraud allegations can also be judged in terms of the effect he expected their dissemination to have upon his tippees. Testifying before representatives of the New York Stock Exchange, Dirks testified (R. 1920) in part:

> But I thought most of them would sell, if you want my opinion.

In light of all of the foregoing circumstances Dirks's testimony at the hearing that he at no time "believed" the fraud allegations is not credited; he obviously could not be sure, but his entire, extended course of conduct establishes that he believed a substantial part of the fraud charges to be more probably true than untrue.

The nature of the inside information is in itself a potent indication of materiality. A reasonable investor would recognize at once that allegations of widespread fraud at EFCA involving top management would, if true, have a devastating effect on EFCA both because of its effect on the assets or real worth of the company and because of the market impact on the

price of its securities. A reasonable investor would also realize that such allegations, in light of what they were and of the total circumstances in which the allegations were received by each selling respondent, would have a sharp negative impact on the price of EFCA securities, whether the allegations ultimately proved to be true or false. This last conclusion is so because a reasonable investor standing in the position of any one of the selling respondents would realize that in light of Dirks's continuing selective dissemination of the allegations, enough recipients of the information would sell the stock (without awaiting the ultimate proof or refutation of the allegations) to seriously depress the market price of EFCA securities.

This consideration of the nature of the inside information as an indication of materiality of course involves application of the probability vs. significance weighing test discussed earlier. The test is particularly applicable to this case. In view of the horrific nature of the fraud allegations, a reasonable investor would not be expected in all cases to wait for proof positive before disposing of his EFCA holdings. And, as III's trader Moore aptly expressed it, a rumor involving fraud would "spread like wildfire" within the brokerage community. III's Zukowski, likewise, recognized that the spreading of such information could be "deadly," as found above. This does not mean that *all* reasonable investors would necessarily react uniformly to the receipt of the information received by each of the selling respondents. But it does mean that a reasonable investor would recognize that a significant enough number of recipients of the information would react by liquidating their EFCA holdings that the price of the stock would be serious affected. Under the "probability yardstick" the fraud allegations were clearly material information.

As a further point under the general question of materiality there remains for consideration how the selling respondents regarded the fraud allegations and how they responded to their

receipt of the information,[47] i.e. the subjective application of the objective materiality tests discussed above. This exposition will show, concurrently, that the inside information received by each selling respondent was a significant element in its decision to sell its clients' EFCA securities. (See pp. 113-14 above).

The findings made herein show clearly that the inside information concerning allegations of fraud at EFCA received by Respondent III was deemed material and that it constituted a significant, indeed controlling, factor in III's decisions to liquidate its clients' EFCA securities. It is sufficient to highlight some of the more salient findings, without attempting to summarize all of the relevant findings.

Promptly after hearing the fraud allegations from Dirks, III initiated and continued extensive efforts to attempt to confirm or refute the information. III thus clearly recognized the significance of the information if true. The efforts at verification, or "checking," eventually involved all portfolio managers at III as well as Wise, who had no primary portfolio responsibility. Courtney had a lengthy face-to-face visit with Dirks and Gorrelick in which the fraud allegations were discussed in considerable detail. In addition, III made a legally-ineffectual stab at seeking legal counsel on the question of whether it was in possession of inside information (the defense of reliance upon legal counsel is treated separately below). Moreover, III, through Zukowski and Baker, continued to have numerous telephone discussions of the matter with Dirks over an extended period, both before and after Dirks carried his investigation to Los Angeles. The last of these contacts was a call

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[47] As suggested above, Dirks clearly viewed the information as material or he would not have been disseminating it to selling respondents and others. Also, as found above, he expected most of the firms he contacted to respond by selling their EFCA holdings, meaning that he expected most of them to regard it as material also.

from Dirks to Baker at the latter's home after Dirks had talked to Majerus, the third ex-employee contacted by Dirks, on the evening preceding III's completing its liquidation of EFCA holdings. Much earlier than the other portfolio managers, Courtney had concluded that the fraud allegations required disposition of the EFCA holdings. Thus, Courtney's clients were sold out first and from that time forward he continued to urge the others to sell. Unlike the others, Courtney did not consider that there was any point in further "checking." In a limited sense Courtney was right, because after extensive checks with a former auditor and with co-insurance companies and others, III was still not in position positively to confirm or refute the fraud allegations. However, as a result of the delay, III did become aware that three former employees told a basically consistent story and that the source therefore was not Secrist alone. These added confirmations, along with the inability to refute the allegations and the circumstances of III's realization that Dirks-induced sales of EFCA securities (including the Courtney-client sales) were already having a negative effect on the market price of EFCA securities and that that trend would continue as Dirks kept up his program of selective dissemination, combined to prompt the ultimate III liquidations. Significantly, III decided to liquidate its clients' very substantial EFCA holdings in the face of a prior determination that they would hold the securities pending an expected rally that had not materialized. III personnel testified that they realized that the fraud allegations and their selective dissemination by Dirks had killed off all possibilities of a rally. Finally, two *res gestae* type actions of III are significant: First, as a direct consequence of the fraud information given by Dirks, III directed brokerage business worth over $23,000 in commissions to Dirks's employer, Delafield Childs;[48]

[48] Testimony that this commission business was unrelated to the inside information furnished is not credited, based upon credibility evaluations and the record as a whole.

second, in reporting to his "bosses" the reasons for the EFCA liquidations, Courtney, employing somewhat euphemistic language, said that III had ". . . received disquieting information from the broker concerning potential adverse developments affecting the company," as found above.

Respondent Bristol & Co., as evident from the facts found above, also considered the allegations of fraud at EFCA that it received material and acted on that information to liquidate its clients' EFCA holdings. (The question of whether certain transactions were "sales" within the meaning of the relevant statutes is treated separately at a later point.) Bristol & Co. first received information concerning alleged fraud at EFCA from personnel at III after III had just completed liquidating its clients' EFCA holdings and at a time when Bristol was in the process of *acquiring* EFCA shares for a client of Bristol & Co. After having purchased 66,000 shares of EFCA for the client on March 22 (which purchase, ironically, came out of shares its affiliate, III, had sold), Bristol & Co. suspended its intended purchase of additional EFCA shares for the client and commenced to check out the allegations with various insurance analysts and two executive vice presidents of EFCA. The EFCA executives denied there was any substance to the rumors and the insurance analysts contacted either discounted the rumors or could not be helpful. Nevertheless Bristol had about concluded that the existence of the fraud allegations and the fact that Dirks was selectively disseminating the allegations dictated a liquidation of Bristol & Co. clients' EFCA holdings even before he and an associate held a telephone conversation with Dirks. Dirks stated that in Bristol's position he would sell and also advised that he (Dirks) had prevailed upon Majerus to talk to the former EFLIC auditors, Haskins & Sells, and that he (Dirks) had been talking to a *Wall Street Journal* reporter. From this last, Bristol inferred that the *Journal* would shortly be coming out with an unfavorable story regarding EFCA. Dirks also expressed the view that he doubted that trading in EFCA would be allowed to continue in view of his contacts with the former auditors. After this con-

versation with Dirks, Bristol & Co. moved to liquidate its clients' holdings in EFCA as rapidly as possible. Clearly, the rapid decision to abort further purchases of EFCA stock and instead to liquidate all clients' holdings in EFCA by Bristol & Co. was caused by its receipt of inside information regarding allegations of fraud at EFCA and knowledge of the circumstances surrounding the selective dissemination of such allegations.

Respondent The Dreyfus Corporation, as the findings herein show, also considered the inside information it received concerning allegations of fraud at EFCA to be material and sold the EFCA debentures of its client, DSIF, on the basis of such information. Before learning of the fraud allegations from Dirks, Dreyfus had placed a sell order for the EFCA debentures with Goldman, Sachs because Quinn considered the holdings inappropriate for DSIF. After learning from Goldman, Sachs that Dirks had a "story" about EFCA and that the market for the stock was unsettled, so that it could be sold only at a deep discount, Dreyfus suspended the sell order pending further checking with Dirks and others. After hearing the fraud allegations from Dirks by phone, Quinn formed the impression Dirks believed them to be true and he called Orphanos at home to have him follow up with Dirks to get further details. Quinn meanwhile decided to meet with Dirks in Los Angeles, since the former was going there on business in any event. Orphanos had a number of phone conversations with Dirks, in one of which he obtained the names and phone numbers of at least 4 former EFCA employees who purportedly knew about the fraud. Over the weekend of March 24-25 Orphanos spoke with ex-EFCA employees Secrist, Thibodeau, and Tickler.[48a] Based on all he had heard, Orphanos came to credit the truth of the fraud allegations and conveyed that view to Quinn. Orphanos reached this view notwithstanding contrary views received from Mercy at Goldman, Sachs and denials from

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[48a] See footnote 31a above.

EFCA's Levin and Arkus-Duntov. Quinn met with Dirks on the evening of March 25. The next day, having been unable to disprove the substantial evidence that the allegations of fraud at EFCA were true, and since Orphanos, in particular, tended to credit the truth of the allegations, Dreyfus sold the debentures. The decision to sell, which involved incurring a loss on an investment that had but recently been made, was motivated by the possession of inside information regarding the allegations of fraud at EFCA and the circumstances concerning the selective dissemination of those allegations.

Respondent Manning & Napier contends that its decision to sell the EFCA stock was made prior to Manning's talking with Dirks and for reasons that were independent of his receipt of inside information regarding the allegations of fraud. The record does not bear out this contention. Although Manning was indeed closely monitoring EFCA along with a half dozen or so other stocks for some time and had considered selling the stock for a week to 10 days prior to the actual sale, the record shows that the sale and the decision to sell were not in fact made until, as found herein, Manning came into possession of the inside information regarding the allegations of fraud at EFCA, including awareness of the market impact selective dissemination of the allegations was having. He responded to such inside information by selling.

The materiality of the specific allegations of fraud at EFCA as contrasted with the materiality of more vague "soft story" allegations is underscored by the disparate responses to the two allegations of Respondent Tomlin, Zimmerman & Parmelee, Inc., as disclosed by the findings above. TZP, after hearing a "soft story" from Dirks was persuaded on March 23 to purchase an additional 3,000 shares of EFCA, even though it considered that Dirks would continue selectively to disseminate that story. This decision was made in the belief that the soft rumors had had their maximum effect and that a substantial purchase would "wash out" the stock. Later, on March 26, after having heard from Dirks the "hard story," i.e. the report of allegations of insurance fraud at EFCA, and after

having come to the belief that Dirks would continue to selectively disseminate *those* allegations, TZP promptly liquidated all of its clients' EFCA holdings.

In support of the selling respondents' contention that the inside information concerning allegations of fraud at EFCA received by them was not "material", they rely heavily upon an argument that runs, in effect, as follows: (1) a number of entities, including the SEC the NYSE, the insurance departments or commissions of various states, the *Wall Street Journal*, and a number of individuals and private entities became aware of the allegations of fraud at EFCA; (2) they did not treat the allegations as "fact" or react to the allegations in a way that would have indicated they regarded them as material; and (3) therefore the allegations of fraud at EFCA that the selling respondents received were in fact and in law not material.

A number of considerations operate to deprive this argument of all but minimal weight.

First of all, as has been seen, the recognized test of materiality is the objective, reasonable-man test. Therefore an argument involving inductive reasoning predicated upon how given individuals or entities viewed particular factual situations is of very limited utility. (Compare pp. 113-4, 123-130 above, where the responses of selling respondents to the receipt of inside information are examined for a dual purpose.)

Secondly, Respondents' argument confronts the difficult task of establishing that the particular factual situation of individuals or entities upon whose reactions they would rely were in fact sufficiently analogous to those encountered by a selling respondent to be valid as an indicator. In a number of instances the record contains no such proof. Again, Respondents would have to show that the individuals or entities whose reactions are relied upon were in the posture of a "reasonable investor," a burden that in some of the reactions upon which they rely they are unable to sustain.

A third flaw in Respondents' argument is the aspect thereof that argues that the individuals and entities upon whose reactions they would rely did not view the allegations of fraud at EFCA "as a fact." This contends that to find materiality here the allegations of fraud would have to have been established as a fact. However, as concluded hereinabove in discussing the probability yardstick test as well as the market-impact and reasonable-investor tests of materiality, there is no rigid requirement that inside information be established as an incontrovertible fact, or anything close to that, before it can be found to be material. The inherent nature of the information and all relevant circumstances under which it is received must be taken into account.

As repsects the actions of the New York Stock Exchange the record shows that on March 22 Jarvis Slade and Saul Cohen of New York Securities reported to the Exchange that at a luncheon meeting of analysts an allegation of fraud at EFCA had been overheard. Dirks was not identified as the person reporting the allegations nor were details of the alleged fraud known or reported. The Exchange contacted EFCA management, which denied the allegation. On Friday, March 23, Goldblum personally met with Exchange personnel in New York City and strongly denied any and all rumors about EFCA, without focussing on the fraud allegations or identifying Dirks as the person reporting the allegations. At first, Exchange personnel tended to accept these denials by management, though they continued to monitor the stock price closely. Later, however, after learning *inter alia* that Dirks was reporting the fraud allegations, and after the Dow Jones Broad Tape carried a report on March 26th that heavy trading in EFCA was accompanied by rumors questioning the accuracy of EFLIC's insurance in force, coupled with appearance of an article of similar purport on March 27, in the *Wall Street Journal*, the New York Stock Exchange halted trading in EFCA. Significantly, the Exchange halted trading in EFCA in recognition of the market impact of the fraud allegations and without awaiting proof of the allegations "as a fact." In short, the Exchange

properly recognized the materiality of the fraud allegations even before certain events on March 30 made it appear highly probable that there was substantial truth to them.

The SEC first learned on March 9 that Secrist had taken his allegations of fraud at EFCA to the New York State Insurance Department. This occurred when an official of the California Insurance Commission met on that date with the Branch Chief of Investment Company Inspection in the Los Angeles Regional Office of the SEC to advise him that the California Commission had been advised of the Secrist allegations by the New York State Insurance Department. The information alleging fraud that was received by the SEC Branch Chief was substantially less detailed and less specific than what Dirks had received from Secrist. Unlike the situation of the selling respondents, the Branch Chief did not receive information that an experienced insurance analyst, Dirks, was reporting the Secrist fraud allegations or that the allegations had been received from more than one former EFCA employee. The Branch Chief tended to disbelieve the Secrist allegations and indicated that in any event SEC personnel were too busy on other matters to be able to assist California in investigating the matter for several months. The Branch Chief's memorandum concerning this meeting did not come to the attention of the Commission's Los Angeles Regional Administrator until Monday, March 26. However, after the Commission's Director of the Division of Enforcement in Washington, D.C. and officials in the Regional Office in Los Angeles were both informed on Friday, March 23, by Blundell of the *Wall Street Journal* that a number of former EFCA employees had alleged fraud at EFCA in talks with him, the Commission took prompt investigative steps that included, *inter alia*, interviews with Blundell on the 26th and interviews and depositions of Dirks, Hopper and Majerus on the 27th. On March 28, without any positive proof of the truth of the allegations of fraud at EFCA and without any certain knowledge as to what was causing the price of EFCA securities to fall, the Commission suspended trading in EFCA. The Commission did so recognizing that

whether the allegations of fraud were being made because of a belief in their truth or as part of a bear raid, and regardless of the truth or falsity of the allegations, the fact of their existence and their selective dissemination were clearly having a negative market impact on the price of EFCA securities. As was true of the NYSE's halt in trading, the Commission acted to suspend trading before the occurrence of certain events on March 30 that made the truth of the fraud allegations appear to be highly probable.[49]

William Blundell, Los Angeles Bureau Chief of the *Wall Street Journal*, first heard the report of allegations of fraud at EFCA from Dirks in a meeting between the two that lasted several hours on March 21. Dirks told him the substance of what he had heard by that time, and gave him names of former employees who might talk to him. Blundell followed up on the allegations personally rather than delegating the matter to a subordinate. After speaking with Secrist, Blundell began an investigation of his own that was to last about ten days and involve interviews of 14 to 20 persons. From March 21 through March 30 he devoted virtually all of his working hours plus some time of his own to investigation of this potential story. By Friday, March 23, he considered the information he then had of significance to the SEC. He thought the Commission might want to consider suspending trading in the stock. After getting Dirks' permission, he conveyed the information, as already found above, both to the Assistant Regional Administrator in

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[49] Late in 1971 an attorney in Los Angeles informed personnel of the Commission's Regional Office in Los Angeles that William Mercado, then an EFCA employe [*sic*], alleged *inter alia* that EFCA carried substantial fictitious insurance on its books. After some investigation and failure to find any supporting or corroborating data, the inquiry was dropped. Assuming, *arguendo*, that staff personnel failed to follow up the lead adequately or perseveringly enough, this would not establish Respondents' argument that such allegations of fraud are inherently incredible and therefore immaterial.

Los Angeles (the R.A. was home ill) and to the Director of the Division of Enforcement in Washington. Between March 21 and March 26 Blundell formed the belief that at least key parts of the fraud allegations were true ". . . after talking to a couple of people at Equity Funding who admitted to me that they had engaged in various criminal actions and who emotionally broke down about this thing." (R. 8702).

On March 26, after EFCA's Goldblum had been reported as denying the rumors about EFCA without being willing to identify the nature or substance of the rumors, Blundell submitted for publication on the Dow Jones Broad Tape at 4:16 p.m. on that day and in the *Wall Street Journal* on the morning of the 27th a brief, generalized characterization of the rumors, already referred to hereinabove (p. 105-6). These two reports stated that the heavy trading in EFCA was accompanied by rumors that centered on the accuracy of EFLIC's reported statements of new policies written and total insurance in force. These general and limited published characterizations of the nature of the rumors concerning EFCA were initiated by Blundell because he felt that in light of Goldblum's denial of the rumors while refusing to state their nature, the "reader", or the "public," was entitled to know at least that much about the nature of the rumors. Blundell commenced writing his detailed "expose" article concerning the EFCA fraud that appeared in the *Wall Street Journal* on Monday, April 2, on the previous Friday, March 30, when he learned that the Illinois Insurance authorities had discovered that $22 million of EFCA assets in the form of bonds supposedly deposited with a Chicago bank were in fact not there and had not been there for a considerable period. Also on March 30th, the California authorities seized EFLIC and Goldblum and Levin chose to exercise their 5th Amendment rights in projected testimony before personnel of the SEC.

When considered in the light of the proper tests for determining materiality, as discussed above, rather than under unsupportable criterion urged by Respondents—i.e. that the allegations of fraud at EFCA would have had to have

been established as fact beyond question (or at least have been universally accepted as fact)—it is clear from the foregoing findings that the reactions of the NYSE, the SEC, and Blundell of the *Wall Street Journal*, once they came into possession of information reasonably equivalent to that received by the several selling respondents, supports rather than negates a finding of materiality.

When Secrist reported his allegations of fraud to the New York State Insurance Department on March 7, the same day he met with Dirks[50] and Gorrelick, he set in motion a chain of reactions that ultimately involved the insurance departments of New York, California, Illinois, and New Jersey in investigating or making inquiry as to those allegations, since each of those states had jurisdiction to one degree or another over EFCA or one of its affiliates. Respondents urge that by and large these state regulatory officials gave little or no credence to the Secrist allegations and that none of them, including Illinois and California, which undertook a joint examination of EFLIC, uncovered any proof that the allegations of Secrist were "fact" until some time after the transactions involving the selling respondents occurred. From these premises, Respondents contend, it follows that the Secrist allegations were not material. Neither of the two prongs of this argument is valid. To treat the second point first, as already discussed extensively above, it is not necessary that inside information be established as proven "fact" or universally accepted "fact" for it to be material. As to the first point, the record shows clearly that the information concerning the Secrist fraud allegations available to the state regulatory personnel was a very long way from being comparable to the inside information that each of the selling respondents had available. In essence, the state regulatory personnel had nothing more than the

[50] As previously found, Dirks did not learn that Secrist had gone to a state insurance department on the East Coast until March 19.

allegations from Secrist (New York and Illinois personnel talked to him in face-to-face meetings while the others received his allegations indirectly in one degree of detail or another). For whatever reasons, the state regulatory personnel did not have the relevant statements of other ex-EFCA employees. Nor did they have the results of Dirks's marathon investigation of the fraud allegations or Dirks's evaluation of the results and import of his investigative activities. There is a significant difference between the allegations of one ex-employee and the totality of information the selling respondents had, including of course the overall circumstances in which they received it. Accordingly, it would be bootless to examine in detail the reactions of the state regulatory personnel since they were not operating on the same information that was available to each of the selling respondents.

Respondents also urge that the allegations of fraud at EFCA were not material because a number of other private persons and entities did not believe them to be, or treat them as, "fact." What has been said heretofore about the principle that materiality does not under the circumstances involved in this proceeding require that the fraud allegations be established as "fact" or universally accepted as "fact" is equally applicable with respect to this argument of Respondents. Moreover, except for persons or entities that were tipped by Dirks directly[51] and except for some officers or employees of EFCA referred to by Respondents, there is lack of satisfactory proof in the record that persons and entities referred to by Respondents had received inside information as extensive, detailed, or legally significant on the materiality issue as that received by selling respondents. As found elsewhere herein, Goldman, Sachs did not possess the same inside information that Respondent Dreyfus did, and there is no satisfactory proof in the record

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[51] As to why some of these "tippees" did not sell EFCA, the record is insufficiently developed to permit findings.

that Salomon Brothers possessed inside information of the nature, detail, or legal significance of that possessed by Bristol & Co. or other selling respondents. Additionally, as to certain entities referred to in Respondents' argument, a strong predisposition not to believe the allegations, quite apart from the nature of the inside information at hand, existed because of special ties to Goldblum or Levin of EFCA. Thus, J. Ira Harris of Salomon Brothers was a long-time acquaintance of Goldblum. Lawrence Tisch, of Loews Corporation, was introduced to Goldblum by Harris. Mercy, of Goldman, Sachs, was a long time personal friend of EFCA's Levin, with whom he talked frequently. Individuals such as these three, because of the special ties, had such strong faith in the integrity of Goldblum or Levin that their reactions to whatever inside information they had was not objective, and their reactions are therefore not significant on the issue of materiality. For somewhat analogous reasons, the fact that some high level officials of EFCA may have disbelieved or discounted the allegations of fraud, does not support Respondents' materiality argument.

Based upon the findings made herein, considered under the legal tests of materiality discussed herein, it is concluded that at the time of the relevant transactions each selling respondent was in possession of *material* inside information regarding EFCA and that in each case the inside information constituted either the only, or a significant, factor in each selling respondent's decision to liquidate its clients' EFCA holdings.

Bristol & Co.'s no-sale defense

Respondent Bristol & Co. concedes that its sale of the 600 shares of EFCA common stock from the Bristol & Co. Employees' Profit Sharing Plan settled in due course with Clark, Dodge & Co. and that it constituted a completed sale. However, respecting the transaction involving 457,200 shares of EFCA common stock, as to which Salomon Brothers refused delivery of the shares and out of which litigation resulted, and respecting the transaction involving $200,000 in face amount of EFCA convertible debentures with Loeb, Rhoades, which did

not settle and has remained open, Bristol & Co. defends on the ground that since there was no completed sale there can be no violation because there was no one to be "defrauded."

In examining this defense it should be noted that the conduct proscribed by Section 17(a) of the Securities Act is substantially identical to the conduct proscribed by Rule 10b-5 under the Exchange Act as pertinent here (see pp. 104-105 above) except that the reach of the respective provisions is in part different in that the former involves conduct "in the offer or sale of any securities" while the latter involves conduct "in connection with the purchase or sale" of any security."

The unsettled Bristol & Co., client transactions, whether or not they occurred in or in connection with a purchase or sale of securities, clearly involved an "offer"[52] of securities, defined in Section 2(3) of the Securities Act[53] to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." The inside-information rule is based as much on Section 17(a) of the Securities Act as it is on Rule 10b-5 under the Exchange Act.[54] Given the purpose and rationale for the inside-information rule—i.e. to protect the integrity and fairness of the securities markets and the public's faith and confidence in them—no reason is apparent why Section 17(a) does not proscribe offers in violation of the inside-information rule as much as it proscribes sales in violation of

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[52] By order dated October 12, 1977, the Division's motion to amend the Order for Proceedings in various particulars in order to conform the Order to the proof was granted. The principal effect of the amendment was to add an allegation that the violations alleged occurred "in the offer or sale" of EFCA securities to the previous allegation that the violations occurred in connection with the purchase and sale of EFCA securities.

[53] 15 U.S.C. § 77b.

[54] *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961); *Investors Management Co., Inc., et al.*, 44 S.E.C. 633 (1971).

the rule. The purpose and rationale for the development of the inside-information rule by the Commission and the courts are fully consistent with the purposes Congress had in enacting Section 17(a), in which it chose to attach the same consequences to offers in violation of the Section's terms as to sales in violation of the Section. Doubtless this was in recognition of the fact that sales frequently result from offers and that even when they do not, offers in violation of the Section can nevertheless have a deleterious effect upon the integrity of the securities markets. The instant situation well exemplifies this. Bristol & Co.'s effort to dispose of 457,200 shares of EFCA common at a discount of $1½ from the market price of $19 and its effort to dispose of $200,000 face amount of EFCA debentures clearly had an impact on the price of EFCA regardless of the fact that the sales did not ultimately settle. This means that sellers in the market sold for less than they would have if Bristol & Co. had not initiated its huge transactions. And, although an individual might be unable to recover from Bristol & Co. because of any of a number of reasons that are significant in litigation between private parties, this does not mean that in a disciplinary enforcement action such as this the Commission is unable to vindicate the public interest. It is well settled that a private litigant's remedy will not always be co-extensive with the Commission's broader enforcement powers as the agency designated by Congress to carry out the primary enforcement role under the securities laws.[55]

In addition, the "unsettled" transactions in EFCA securities initiated by Bristol & Co. on behalf of its clients constituted sales as defined in § 3(14)[56] of the Exchange Act, which defines the term "sale" to include "any contract *to* sell." (Emphasis added). When the EFCA common stock of Bristol & Co.'s clients was traded over the NYSE or crossed, in-house, Bristol

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[55] *Fridrich* v. *Bradford*, 542 F.2d 307, 320-21 (6th Cir. 1976).

[56] 15 U.S.C. § 78c(14).

& Co. had, through its selling broker, Salomon Brothers, concluded executory contracts to sell with Salomon Brothers' customers, Salomon Brothers' house account, and the numerous other ultimate purchasers set forth on Division's Exhibit 42, Schedule C. The Act's definition of sale as including a "contract to sell" does not concern itself with whether the contract to sell is void or voidable for fraud or any other reason or with whether there is ultimately an exchange of stock for value.

Similarly, when Bristol & Co. solicited and accepted Loeb, Rhoades' bid for the 200 EFCA debentures, it entered into an executory contract to sell within the meaning of the Exchange Act.

Cases relied upon by Respondent Bristol & Co. that require a settled or completed sale in private litigation presenting questions of standing to sue or the ability of a plaintiff to prove damages are simply not relevant in this disciplinary enforcement proceeding, where the Commission is vested with authority to vindicate the public interest in a much broader sense. As found above in discussing the "unsettled" transactions as offers under the Securities Act of 1933, the record contains ample evidence that such offers adversely affected the market for EFCA securities and therefore damaged participants in that market during the relevant period. The market and investors treated these trade-date transactions in EFCA the same as any other transactions in these securities, regardless of the fact that the trades did not ultimately settle.

As bearing in a general sense on the broad scope of the public interest that the Commission is required to vindicate, it is not without significance that Respondent Bristol & Co. seeks to avoid responsibility for any consequences flowing out of the unsettled transactions even though it was its own alleged misconduct that caused the intended sales to be aborted or not carried to fruition and even though it has itself never sought to rescind these contracts to sell.

The Division further contends that as respects some 20,000 shares of the 457,200 shares "traded" by Bristol & Co. on behalf of its clients the trades actually did settle.[57] The record contains uncontradicted testimony that this occurred—not through delivery or surrender of any stock certificates of Bristol & Co.'s clients, but through operation of the on-balance clearing and settlement procedure.[58] Salomon Brothers on the date in question evidently had other transactions in EFCA stock and in the balancing out or netting out process some 20,000 shares of EFCA stock got delivered to purchasers identified on Exhibit 42 as purchasers of the stock Bristol & Co. had agreed to sell on behalf of its clients.[59] These results were forseeable [*sic*] by Bristol & Co. and justify treatment of the transactions represented by the 20,000 shares as completed sales.

Lastly, as to this defense, the Division claims that Bristol & Co.'s participation in a settlement of litigation involving it and Salomon Brothers, among others, constitutes acknowledgement by Bristol & Co. that it did, at least *pro tanto*, engage in sales of EFCA stock on behalf of its clients. In view of the diverse reasons for which parties enter into settlements, and in view of the "clear and convincing" standard of proof being applied in this decision, no such inference is drawn here from the mentioned settlement.

Failure to disclose

The record establishes, as found herein, that each selling respondent failed to disclose material inside information prior

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[57] These included purchases by Lily Levy and Walter Rogers, who testified that they bought and paid for EFCA stock.

[58] See Stock Clearing Corporation Rule 8, NYSE Guide, CCH ¶ 3308.

[59] The record does not show precisely the source of these 20,000 shares of EFCA stock or whether there was any effort to reverse or rescind these settled sales after Salomon Brothers refused to accept delivery of EFCA stock from Bristol & Co.

to entering into the transactions that form the basis for its alleged violations. Only Respondent Dreyfus contends it did make proper disclosure. Respondents Dreyfus and Bristol & Co. contend they were not required to disclose because the other sides to their respective transactions already had substantially the same inside information these Respondents had.

As found herein (pp. 54-5 above) Quinn of Dreyfus conveyed to Mercy of Goldman, Sachs on Friday, March 23, the substance of certain allegations of fraud at EFCA that Quinn had heard on that date in a telephone conversation with Dirks. Mercy, as found above, expressed disbelief in the allegations, attributed to a "former employee" of EFCA, that EFLIC had put hundreds of millions of dollars of bogus insurance representing tens of thousands of fictitious policies on its books, had fraudulently re-insured the bogus insurance, and had issued phony death certificates as part of the scheme.

However, as found herein, Dreyfus did not disclose to Goldman, Sachs any information the former received in its continuing investigation into the matter subsequent to Quinn's conversation with Mercy of March 23. As found herein (see pp. 56-9 above), this information subsequently acquired by Dreyfus included significant elements of inside information going beyond that which Quinn had related to Mercy. Without repeating the previous findings in detail, certain significant items may be noted. Dreyfus learned subsequently in further conversations with Dirks that Don Goff, a *current* employee of EFCA, "confirmed" the alleged fraud. Dreyfus also obtained from Dirks the names and telephone numbers of four former EFCA employees with whom Dirks had spoken, including Secrist, his original informant. Over the weekend of March 24-25 Orphanos of Dreyfus personally telephoned Secrist and two other former employees of EFCA, Thibodeau and Tickler.[59a] Either by what they told him, or by how they re-

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[59a] See footnote 31a above.

sponded, these ex-employees tended to confirm the allegation of fraud at EFCA.

On the evening of Sunday, March 25, Quinn met with Dirks in Los Angeles. At this meeting Dirks told Quinn that Dirks had contacted additional employees since their last telephone conversation, who corroborated information he had gotten earlier, and that Dirks had begun to fear for his personal safety after having been cautioned by a representative of EFCA's former auditors. Dirks also told Quinn that he had arranged with Majerus and Hopper to meet with Blundell of the *Wall Street Journal*, to whom Dirks had relayed the allegations of fraud at EFCA, and that he had requested Majerus, former comptroller of EFLIC, to tell his story to a Mr. Balint, the partner-in-charge at Haskins & Sells, EFLIC's former auditors. Dirks advised that Majerus had called Balint.

These items of inside information acquired after the March 23 Quinn-Mercy phone call were all highly material, tending as they did to corroborate the earlier report of allegations, which attributed the allegations to a single ex-employee. They should have been disclosed to Goldman, Sachs.

Dreyfus argues broadly that Goldman, Sachs knew as much or more than Dreyfus knew about the allegations of fraud at EFCA. But there is no support for this contention in the record. There is nothing to support a finding that Goldman, Sachs was aware that 3 or more ex-employees and one current employee of EFCA all tended to confirm the fraud allegations, or that they were in possession of the other material inside information that Dreyfus acquired after the March 23 phone call. While there is evidence that Mercy made numerous phone calls to his friend Levin at EFCA regarding the rumors or allegations, there is nothing in the record to show that Goldman, Sachs as a result of such conversations or otherwise learned the material inside information that Dreyfus acquired after the March 23 phone call. Since Goldblum and Levin were "stonewalling" in response to all inquiries about the rumors, it seems highly unlikely that either would have furnished any

kind of detail regarding the allegations that could be construed as tending to corroborate them.

The Division also contends that even if Dreyfus had made adequate disclosure to Goldman, Sachs that would not have been enough. The Division contends that, even though Goldman, Sachs purchased the EFCA debentures from Dreyfus's client on a principal basis, the transaction cannot be regarded for disclosure purposes as comparable to face-to-face private transactions. This, the Division urges, flows from the fact that Goldman, Sachs during the relevant period was in effect functioning as a market maker in EFCA debentures and that Dreyfus was well aware that Goldman, Sachs was so functioning. Therefore, the argument concludes, public disclosure rather than disclosure merely to the purchaser was required.

While the Division's position on this point is considered to have great merit, particularly in light of the nature of the inside information here involved, it is unnecessary to rule expressly on the point in view of the conclusion reached herein that material inside information acquired by Dreyfus subsequent to the March 23 Quinn-Mercy phone call was not disclosed to the purchaser (Goldman, Sachs).

With respect to Bristol & Co.'s defense as regards its lack of disclosure, it must be noted at the outset that it is not claimed to be applicable to the 600 shares of common stock sold to Clark, Dodge & Co. or to the $200,000 face value convertible debentures contracted to be sold to Loeb, Rhoades. The defense applies only to offers or agreements to sell made to or through Salomon Brothers. The intended ultimate purchasers, including Salomon Brothers, some of its customers, and other broker-dealers or their customers, are shown on Schedule C of Division's Exhibit 42. The defense is that Salomon Brothers (and a few of its major customers) were as aware of the fraud allegations as Bristol & Co. was, that information possessed by Salomon Brothers would be imputed in law to ultimate purchasers for whom it acted as agent, and that there was thus no legal necessity for making disclosure to Salomon Brothers.

Bristol & Co. does not claim it was aware on March 26, the trade dates of the relevant transactions, that Salomon Brothers (or any of its clients) had the inside information.

The (partial) defense lacks merit for two major reasons.

First, the record does not substantiate the claim that Salomon Brothers (or its major customers) had material inside information of the same or substantially the same significance as Bristol & Co. had. While Salomon Brothers and some of its major customers were aware of the allegations of fictitious insurance at EFCA and that Dirks was the source of the allegations, and, indeed, had discussed the allegations with Goldblum and other personnel of EFCA, who denied they had any validity, there is no proof in the record that Salomon Brothers, *et al.* had the kind of corroborating details that increased likelihood that Bristol & Co. had. (Incidentally, Bristol & Co. did not call witnesses from Salomon Brothers to attempt to establish the nature or extent of their knowledge of the fraud allegations). For example, Bristol & Co., as found herein, was told by Dirks that he had talked to a number ("various") former employees of EFCA and that the situation did not look good (the inference would be that the various employees interviewed corroborated one another). Also, Bristol received a "recommendation" from Dirks to dispose of the stock, based on his by then lengthy and extensive investigation into the Secrist allegations. Furthermore, Bristol & Co. learned from Dirks that he expected an unfavorable *Wall Street Journal* report to come out imminently and that he also expected a trading halt or suspension in EFCA securities shortly. So far as the record shows, Salomon Brothers *et al.* had none of these significant, corroborative elements of material inside information—most of what they had by way of "inside" information were fervent but generalized denials from top EFCA management.

From a legal standpoint, too, Bristol & Co.'s partial defense respecting disclosure lacks merit. There is clearly no principle of law under which any knowledge Salomon Brothers may have

had can be imputed to the numerous ultimate intended purchasers in the transactions in which Salomon Brothers acted as agent for Bristol & Co. and traded on the NYSE with contra brokers acting for ultimate purchasers, e.g. Levy and Rogers.

Since Bristol & Co. had no understanding or reason to believe that Salomon Brothers was purchasing the EFCA stock for its own account, disclosure to Salomon Brothers alone would not have sufficed—full public disclosure was required before transactions could be entered into.[60]

Wilfulness, scienter, and related issues

Respondents contend that under the holding of the Supreme Court in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), a showing of scienter, i.e., "a mental state embracing intent to deceive, manipulate, or defraud" is required under both Sec-

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[60] In *Dupuy* v. *Dupuy*, 551 F.2d 1005, 1015 (5th Cir. 1977) the Court, in the context of a private suit presenting the question whether the plaintiff had exercised due diligence to protect himself against alleged fraud, in discussing the distinct requirements applicable in private suits as contrasted with enforcement proceedings, stated in part as follows:

> ". . . The dispositive element in these [the enforcement] cases is that the defendant owes a duty of full and fair disclosure to the public, not to any particular investor. Whether a private plaintiff might be precluded from recovery, then, need not alter the distinct consideration whether a defendant has violated duties imposed by the Act. . . ."

A commentator makes the point as follows:

> Since in any active market disclosure to a particular individual is not feasible, the duty to disclose, if such a duty exists, must be owed to all members of that ill-defined class of stockholders who, with the benefit of inside information, would alter their intention to [buy].

Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 Colum. L. Rev. 1361, 1378 (1965).

tion 10(b) of the Exchange Act and Rule 10b-5 thereunder and Section 17(a) of the Securities Act.

As to Section 17(a), it is concluded that Respondents' argument is not well founded. *S.E.C.* v. *World Radio Mission, Inc.*, 544 F.2d 535, 541 n. 10 (1st Cir. 1976); *contra, Sanders* v. *John Nuveen & Co., Inc.*, 554 F.2d 790 (7th Cir. 1977); *S.E.C.* v. *American Realty Trust*, 429 F. Supp. 1148, 1171 (E.D., Va. 1977). *The World Radio* court stated, in the footnote cited, as follows:

> 10. Defendants engage in a technical argument, that since the language of section 17(a) of the 1933 act is virtually identical to that of Rule 10b-5 and since *Hochfelder* read section 10(b) of the 1934 act, under which Rule 10b-5 was promulgated, as requiring scienter, section 17(a) must be similarly interpreted. This is a non sequitur. The *Hochfelder* Court recognized that Rule 10b-5(2), making it unlawful "to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading," is not, by itself, limited to intentional deceit; but the Court held that the rule, if so interpreted, would exceed the authority of section 10(b) of the statute. 425 U.S. at 212-214, 96 S.Ct. at 1390-1391. Section 17(a), however, is a congressional enactment, not an SEC rule, and it contains the same language which the *Hochfelder* Court recognized did not require scienter. Thus, strictly speaking, since this action is founded on both section 17(a) and Rule 10b-5, we need not decide what result would obtain in an SEC injunction action based solely on section 10(b) and Rule 10b-5—though we do think it implausible to suppose that Congress intended to provide a mechanism for the SEC to protect the public from the injurious schemes of those of evil intent and yet leave the public prey to the same conduct perpetrated by the careless or reckless.

Although *World Radio* was a suit for injunction, its rationale on the point at issue is equally persuasive in enforcement proceedings such as this. Moreover, the rationale applies both

to the second and third numbered clauses of Rule 10b-5 and Section 17(a), respectively. See *Hochfelder*, *supra*, 425 U.S. at 212. The reasoning of *World Radio* and the clear implications of *Hochfelder* itself are persuasive and are not negated or attenuated by any of the contrary holdings. Further authority supporting this conclusion as to Section 17(a) is found in *Steadman Securities Corp., et al.* [current] Fed. Sec. L. Rep. (CCH) ¶ 91,243 (Investment Company Act Release No. 9830, June 29, 1977), *appeal pending* (5th Cir.); 12 SEC Docket 1041, July 12, 1977.

As to Rule 10b-5, *Hochfelder*, *supra*, was silent as to applicability of the scienter requirement to SEC administrative enforcement proceedings, though it expressly reserved judgment as to its applicability to SEC injunctive suits. The Commission in *Steadman*, *supra*, concluded that proof of specific intent to defraud was not required by *Hochfelder* in SEC disciplinary enforcement proceedings.

Since the Commission there found the "scienter" requirement to have been met, conclusion was technically dictum; nevertheless its treatment of the issue suggests the Commission intended it as a definitive statement of its position.

The only judicial decision offering any view on the issue in a disciplinary proceeding is *Arthur Lipper Corp.* v. *S.E.C.*, 547 F.2d 171, 180-81, n. 6 (2d Cir. 1976) *rehearing denied* March 22, 1977, 551 F.2d 915, *certiorari denied*, 46 U.S.L.W. 3429 (Jan. 10, 1978). There the Court assumed, *arguendo*, without deciding, that the *Hochfelder* culpability standard was applicable to SEC disciplinary enforcement proceedings but, since it concluded that on the facts that standard had been met, the Court found it unnecessary to decide the point.[61]

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[61] Judge Friendly, writing for the Court, seemed to express a leaning in favor of a view that *Hochfelder* does apply to SEC administrative enforcement proceedings. However, the language quoted from the opinion in *World Radio*, *supra*, would seem to suggest a

In the instant proceeding it is likewise not necessary to decide whether the *Hochfelder* scienter requirement applies under Rule 10b-5. This is so for two reasons. Firstly, the findings herein establish that the culpability standard of *Hochfelder* has been met, and, secondly, if a reviewing tribunal should conclude that intent to deceive within the meaning of Rule 10b-5 had not been established, violations as charged would nevertheless be established under Section 17(a), under which intent to deceive need not be established.

In determining what the proper standard of culpability was in an SEC administrative disciplinary proceeding under an assumption of *Hochfelder's* applicability, Judge Friendly in *Lipper* wrote in part as follows (547 F.2d at 181):

> Putting aside for the moment the defense of reliance on the advice of counsel, we do not regard the *Hochfelder* decision as carrying the day for petitioners. The Court held that in order to create liability for damages under Rule 10b-5—and we assume in petitioners' favor that the same standard governs proceedings under §15, see fn. 6—there must be proof of intention "to deceive, manipulate, or defraud" — not in intention to do this in knowing violation of the law. The Court reasoned that the language of §10 suggested that the section "was intended to proscribe knowing or intentional misconduct," 425 U.S. at 197,

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belief that Congress could not have intended the *Hochfelder* culpability requirement to apply to Section 10(b) enforcement actions since it provided otherwise (as the Court concluded) with respect to Section 17(a), whose provisions are substantively identical to those of Rule 10b-5. Conceivably the ruling in *Hochfelder* could come to be narrowly applied to its facts, i.e. cases involving private litigants relying on a judicially-inferred right to sue, since a substantial measure of the Court's reasoning in *Hochfelder* depends upon statutory provisions for private litigants in other sections of the Exchange Act.

96 S.Ct. at 1383.[7] It thought that use of such words as "manipulative," "device," and "contrivance" made "unmistakable a congressional intent to proscribe a type of conduct quite different from negligence," 425 U.S. at 199, 96 S.Ct. at 1384. And it referred, 425 U.S. at 202, 96 S.Ct. at 1385 to the oft-cited testimony of a sponsor of the Act before the House Committee on Interstate and Foreign Commerce that what became §10(b) says "Thou shall not devise any other cunning devices." While that phrase could not be regarded as including negligence, it reads precisely on what petitioners did here — charging the full NYSE commission rates on IOS generated OTC transactions and rebating half of these to IPC, a subsidiary of IOS, knowing that IPC would retain the sums paid to it although these should have been turned over to the funds directly or applied to reduce the advisory fee. It is no answer that petitioners may not have realized that this "cunning device" was a fraud.

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7. Indeed, even in the criminal context neither knowledge of the law violated nor the intention to act in violation of the law is generally necessary for conviction. The first proposition seems implied by the rule *ignorantia juris non excusat*. Hall, Criminal Law 288 (2d ed. 1961). And the second, of course, follows from the first. Perkins, Criminal Law 745 (2d ed. 1969). See ALI, Model Penal Code §§ 1.13(12), 2.02(2)(a) & (b); *Ellis* v. *United States*, 206 U.S. 246, 257, 27 S.Ct. 600, 602, 51 L.Ed. 1047 (1907), where, in rejecting a claim that knowledge of the law was required for conviction under a statute that included the word "intentionally", Justice Holmes said, "If a man intentionally adopts certain conduct in certain circumstances known to him and that conduct is forbidden by the law under those circumstances, he intentionally breaks the law in the only sense in which the law ever considers intent." [Remainder of footnote omitted.]

In the instant proceeding the record and the findings establish that each selling respondent acted entirely or in material part on the basis of material inside information concerning fraud at Equity Funding in selling, offering to sell, or agreeing to sell, EFCA securities to known or unknown purchasers without disclosing to such purchasers the inside information in its possession. In each case the decision to sell, offer, or agree

to sell was knowing, deliberate, and intentional, not inadvertent or negligent. In each case the decision to withhold the inside information from purchasers or prospective purchasers rather than to disclose it was knowing, deliberate, and intentional, not inadvertent or negligent. The fact that each selling respondent acted in whole or in material part on the basis of the inside information, under circumstances found herein, indicates its awareness that the inside information was material. It was clear that the information was from inside sources. And Respondents were well aware of the long-settled law that selling on the basis of material inside information without proper disclosure is a fraudulent or deceptive act, practice, or course of business. Thus, their knowing, intentional commission of such an act or practice itself evidences an intent to deceive the purchasers. Intent to deceive is inherent in the nature of the offense, absent inadvertence or good faith considerations.

The Commission in *Steadman*, *supra*, 12 S.E.C. Docket at p. 1051, found an intent to deceive under the following analysis:

What we have here is:

(1) a duty to reveal; plus
(2) an intent to conceal; and
(3) actual concealment.

These elements are all present in the instant proceeding.

Likewise, the findings made herein more than meet the culpability standards applied by the Court in *Lipper*, *supra*, under its assumption of *Hochfelder's* applicability to administrative disciplinary proceedings brought by the Commission. In *Lipper*, Judge Friendly concluded that "[i]t is no answer that petitioners may not have realized that this 'cunning device' was a fraud." *Supra*, 547 F.2d at 181.

Respondents contend they could not have had the requisite intent to deceive because they did not believe the allegations of fraud at EFCA. However, as developed above, under the "probability yardstick" test for materiality, it is not necessary

that an allegation having significance be established as fact or universally believed before it becomes material. As already noted, each selling respondent did in fact act on the basis of inside information and the fact of having acted on the basis of the information itself evidenced recognition of its materiality. Respondents' argument that they did not recognize the materiality of the inside information they acquired is therefore not persuasive. Thus selling Respondents knew or should have known they would be committing a wrongful act, a deception of the purchasers, if they failed to disclose the inside information each had. Moreover, under *Lipper*, knowledge that they were acting in contravention of law would not be required to satisfy the scienter requirement.

The argument of some Respondents that they believed the inside information they had was already public knowledge is so lacking in support in the record as to come close to being frivolous.

Respondents contend they acted in good faith because state insurance laws and libel laws prohibited publication or dissemination of the allegations of fraud at EFCA and that they lacked other means of ensuring that the allegations became public, while their fidcuiary [*sic*] obligations compelled them to sell in the face of falling EFCA prices and circulating allegations of fraud.

The "dilemma" erected by Respondents in [*sic*] illusory, a chimera.

It is settled law that a trustee's obligations to his or its beneficiaries do not require the commission of an illegal act. See Scott, *Trusts*, §§ 61, 166 (3d. ed. 1967). The Commission has stated in *Investors Management Co., Inc., et al.*, 44 S.E.C. 633, at p. 647 (1971), in pertinent part as follows:

> . . . The obligations of a fiduciary do not include performing an illegal Act [*sic;* footnote citations omitted] . . . And there is no basis for the stated concern that a fiduciary who refrains from acting because he has received what he believes to be restricted information would be held dere-

> lict if it should later develop that the information could in fact have been acted upon legally. If that belief is reasonable, his non-action could not be held improper.

Cady v. *Roberts*, 40 S.E.C. 907, 916 (1961) is to the same effect.

Under the facts in the instant proceeding, Respondents would have been justified, indeed required, to refrain from trading in the absence of a proper disclosure. In view of this it is unnecessary to consider whether State insurance laws precluded disclosure (on their face, some of the statutes cited appear not to be germane) or the effect of libel laws. Likewise, it is unnecessary to consider whether other avenues for getting the requisite disclosure made were closed to Respondents. In passing, it may be observed that Respondents made no effort to contact the NYSE[,] the SEC, or any other regulatory body that might have been in position to require or influence EFCA to make proper discosure [*sic*] of the allegations of fraud at EFCA.

Respondents III, Bristol & Co., and Dirks urge reliance upon advise [*sic*] of counsel as evidence of good faith.

The Commission holds that reliance upon advice of counsel may be used in mitigation on the issue of sanctions but cannot make unlawful conduct legal. *Arthur Lipper Corporation*, Securities Exchange Act Release No. 11773, October 24, 1975, at p. 16, n. 41, *affirmed in part, reversed as to sanctions*, *Arthur Lipper Corp.* v. *S.E.C.*, 547 F.2d 171, 181-2[82] (2d Cir. 1976), *cert. den.*, 98 S.Ct. 719 (1978).

Apart from the legal effect of reliance upon advice of counsel in appropriate circumstances, it is clear from the facts found

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[82] In rejecting petitioners' contention of reliance on counsel, the Court concluded the defense was not available because counsel was unable to give wholly disinterested advice and therefore found it unnecessary to consider the Commission's ruling on the point.

herein that none of the three claimants establishes good faith reliance upon advice of counsel.

III, which sought legal advice after it first heard something of the fraud allegations from Dirks, materially misinformed Attorney Evans of the recency of the informant's employment with an EFCA affiliate. In a second phone call, on March 14, Courtney failed to tell Evans about the fact of and substance of Courtney's long face-to-face discussion with Dirks and Gorrelick on the following day. III never re-checked with Evans after III collected additional corroborative information from continued contacts with Dirks and as a result of other extensive checking III did. Moreover, III breached Evans' admonition not to contact EFCA directly *or indirectly* by talking to EFLIC's re-insurers and to Dirks, who talked to additional EFCA ex-employees, i.e. Hopper and Majerus. In short, III's attempt to obtain a legal opinion was perfunctory. Evans never received the full information required to enable him to render an informed opinion and his caveat was not fully observed. In these circumstances III's claim of good faith reliance upon the advice of counsel is not substantiated.

Bristol & Co.'s claim to reliance in good faith upon advice of counsel is even less well founded than that of III. Bristol & Co. relies upon the fact that on March 23 III's Baker told Bristol & Co.'s Smith that III had sought and obtained an oral legal opinion and guidelines from Evans. Bristol & Co. was unaware of what "facts" III had given or failed to give Evans as the basis for his legal opinion. In any event, the "facts" confronting III when it sought legal advice were not the "facts" confronting Bristol & Co. when it should have sought a legal opinion of its own. Dirks told Bristol on Monday, March 26, that he had talked to various EFCA employees over the weekend—*after* III had liquidated on the 21st—and that what he had heard "was not good" and that if Dirks were in Bristol's position he would sell the EFCA stock. In addition Bristol formed the impression from his conversation with Dirks that the *Wall Street Journal* would soon be coming out with an unfavorable story on EFCA. In addition, Dirks told Bristol he doubted

trading would continue in EFCA securities because Dirks had talked to the former auditors, Haskins & Sells, and had prevailed upon the former Comptroller of EFCA [Majerus] to talk to Haskins & Sells about the fraud allegations. All of these were significant elements of information that Bristol & Co. had that III could not have had when it sought Evans's legal opinion. Moreover, Bristol & Co. violated the "guidelines" Evans had given III by talking directly to Levin and Arkus-Duntov, two top level officers of EFCA, in an attempt to obtain confirmation or denial of the fraud allegations. In view of these deficiencies and other relevant circumstances, Bristol & Co. can hardly claim reliance in good faith upon advice of counsel.

Dirks's asserted good-faith reliance upon the advice of counsel is clearly contradicted by the record. He contends that on March 14 and again on March 21 he was told by personnel of III that III had informed its counsel [Evans] of the Secrist allegations in detail and had been advised that the fraud allegations were not covered by the inside information rule and that Secrist was not an insider. There is no indication in the record that III led Dirks to believe that it had sought or obtained any legal opinion subsequent to March 14. As the findings herein abundantly evidence, Dirks kept receiving additional inside information from additional insiders subsequent to March 14 and through March 26 on a continuing basis, and he selectively disseminated such information during that period. Obviously an opinion rendered on the basis of information available as of March 14 would not necessarily be valid on the basis of "facts" Dirks kept accumulating thereafter, and he had no reason whatever, as a sophisticated and experienced analyst, for supposing that it would.

Dirks also relies on his having disclosed the Secrist fraud allegations to Richard Weiss, an insurance lawyer whom Dirks had on occasion engaged, without receiving from Weiss any reaction or advice that this was inside information. The disclosure occurred in a chance meeting on March 19, before Dirks took off for Los Angeles to pursue his investigation in greater earnest. Weiss was neither asked for, nor did he volunteer, an

opinion as to whether the Secrist allegations of fraud were inside information. Dirks relies on Weiss's silence as indicating that everything was all right. The record does not indicate that Weiss was qualified or experienced in securities law so that he could have rendered a reliable opinion had one been requested. And, of course, as indicated with reference to the Evans legal advice, even if Weiss had rendered an opinion on the 19th, it would not have held good without further consultation in light of the significant additional inside information Dirks acquired from other inside sources after March 19th and through March 26th. Dirks is far too experienced and sophisticated to have been under any good faith belief that he had any basis for relying upon "advice of counsel" upon either of the bases discussed above.

Respondent Dirks also urges that his gathering of information concerning the allegations of fraud at EFCA and his selective dissemination thereof are protected by the free speech provisions of the First Amendment to the Constitution. The argument lacks merit.

The findings herein make it clear that Dirks was involved in such activities not as an agent of the press or as a free-lance newsgatherer but in his capacity as an analyst of insurance company securities. Thus, if Dirks is to gain any comfort from the First Amendment it must come from the cases applying the First Amendment to commercial speech.

But the law is clear that the protection afforded to commercial speech is not absolute — that it does not remove a business engaged in the communication of information from general laws regulating business practices. The principle was well stated in *Savage* v. *C.F.T.C.*, 548 F.2d 192, 197 (7th Cir. 1977), where the Court stated in pertinent part:

> Commercial speech is entitled to a measure of First Amendment protection, *Virginia State Board of Pharmacy* v. *Virginia Citizens Consumer Council*, 425 U.S. 748, 96 S.Ct. 1817, 48 L.Ed. 2d 346 (1976), but it has long been recognized that the Amendment does not remove a business engaged in the communication of information from

general laws regulating business practices. As Justice Harlan stated in *Curtis Publishing Co.* v. *Butts*, 388 U.S. 130, 150, 87 S.Ct. 1975, 1989, 18 L.Ed.2d 1094 (1967):

> "A business 'is not immune from regulation because it is an agency of the press. . . .' Federal securities regulation, mail fraud statutes, and common-law actions for deceit and misrepresentation are only some examples of our understanding that the right to communicate information of public interest is not 'unconditional.' " (Citations and footnotes omitted).

Dirks argues that there was a "significant public interest" in the allegations of fraud at EFCA. Of course there was. And Rule 10b-5 and Section 17(a) are designed among other things to ensure that the public at large will obtain access to such information since it is material to investment decisions. But the effect of Dirks's activities at least in the short term was to give such information not to the public at large but selectively to a small fragment of the investing public. Dirks's argument would turn violation of law into virtue.

Dirks also urges in connection with his First Amendment defense that judicial decisions applying it hold that its protection is unavailable only if he acted in violation of law with scienter. The cases relied upon are, in my view, misconstrued or misapprehended. However, since the findings herein conclude that Dirks did act with the requisite scienter to support findings of the charged violations, it is unnecessary to discuss these particular First Amendment cases.

As found herein, Dirks disseminated the allegations of fraud at EFCA selectively in the expectation and belief that most of the recipients of the information would act on it and sell their EFCA holdings. He continued to disseminate such inside information after he had received strong indications that at least two recipients of the information had acted on it to sell substantial quantities of EFCA securities. On these and on all the findings affecting Dirks it is concluded that he acted in the expectation, and with the intent, that a percentage of the recipients of the inside information would act upon it and liquidate their EFCA holdings.

Dirks's motivations for the selective disseminations were twofold. Firstly, he hoped that his selective disclosures, by depressing the price of the EFCA securities, would be instrumental in leading to exposure of what he believed, as previously found herein, was probably a fraud at EFCA. Secondly, the selective dissemination was expected by Dirks to develop good will towards him and his brokerage firm among actual or potential clients for his services as an analyst. With respect to III, as found, it actually resulted in commission business for his firm.

That Dirks concurrently with his selective dissemination to others also disclosed the inside information to *Wall Street Journal* reporters and urged them in effect to print the allegations does not negate his intent or scienter with respect to the selective disclosure to others. Dirks proceeded on two tracks, both heading towards the same result — ultimate exposure of what he believed was probably a fraud. Had Dirks confined his disclosures to the *Wall Street Journal* reporters (or had he gone to cognizant regulatory or self-regulatory bodies) instead of also disclosing selectively to investors, he might indeed have been perceived as the public-spirited hero he seeks to portray himself as in this proceeding. He chose, instead, to employ the two-track pattern he in fact employed out of a belief, as evidenced by the entire record and observation of Dirks and other witnesses, that these methods would give him higher visibility and greater public recognition as an analyst and an opportunity at the same time to develop direct good will and potential future clients as respects the firms to whom he selectively disseminated the inside information.

If the record did not establish, as found herein, that Dirks acted with the expectation and intent that a number of the tippees to whom he selectively disclosed inside information concerning the EFCA fraud allegations would act on such information, it would at the very least establish that he acted in reckless disregard of the foreseeable consequences of his campaign of selective disclosure.

Respondent Dirks also contends in effect that for him to be found to have wilfully aided and abetted violations by the selling respondents it must be established (1) that his conduct would not subject him to primary liability for violation of Rule 10b-5 or Section 17(a); (2) that a selling respondent committed a violation as charged; (3) that Dirks knew that his role was part of the overall fraudulent activity leading to a violation by a selling respondent; (4) that Dirks acted with the specific intent to defraud; and (5) that Dirks substantially assisted the violation.

Contention (1) above is made on the premise that since *Texas Gulf Sulphur, supra*, 401 F.2d 833, 852-3 establishes that a "tipper" such as Dirks may be primarily liable for a Rule 10b-5 violation he cannot logically be "secondarily" liable as an aider and abetter for the same acts or conduct. Evidently Dirks makes this point out of concern that some lesser level of culpability may apply to aiding and abetting than applies to "primary" violations. In *Texas Gulf*, a suit for injunction, the tipper was held to have violated Rule 10b-5. His tippees were not parties to the suit, though there was a finding that some acted on the basis of the "tips".

In the instant disciplinary enforcement proceeding, it would seem that Dirks's conduct more properly constitutes an aiding and abetting although, logically, contrary to Dirks's contention, there is no reason why the tipper's act, if tipping is itself a violation under applicable case law, could not also be an aiding and abetting where the facts and law warrant such findings and conclusion.

In any event, it is clear from the findings herein that all of Dirks's suggested criteria for finding an aiding and abetting violation are met here. Dirks clearly substantially assisted the violations by selling respondents — indeed he put into motion the whole chain of events that resulted in such violations. Dirks was also well aware that his role was central to the violations by others — as found herein he was aware that others had sold on the basis of fraud allegations conveyed by him and he

expressly advised Bristol that if he were in his situation he would sell the EFCA securities. Moveover [*sic*], Dirks expected most of his tippees would sell and wanted them to do so in order to achieve his purpose of exposing what he believed to be a probable fraud at EFCA. Dirks knew that the clearly foreseeable consequence of his disclosures of material inside information was that purchasers would be defrauded and he was willing to have that occur as the price of exposing the probable fraud and advancing his own interests with actual or potential clients. Thus, he intentionally aided and abetted the defrauding of purchasers (and of the investing public generally).

Conclusions of law

In general summary of the foregoing, it is concluded that during March of 1973, the indicated respondents committed violations of the following provisions of law or rule as a result of the following acts, practices, and failures to disclose, all as more particularly found above:

(1) On particular dates in March, 1973, as more particularly found above, Respondents The Boston Company Institutional Investors, Inc., John W. Bristol & Co., Inc., The Dreyfus Corporation, Manning & Napier, and Tomlin, Zimmerman & Parmelee, Inc. wilfully violated Section 17(a) of the Securities Act of 1933, as amended, 15 U.S.C. §77q(a), Section 10(b) of the Securities Exchange Act of 1934, as amended, 15 U.S.C. 78j(b) and Rule 10b-5 thereunder, 17 CFR § 240.10b-5 through use of jurisdictional means, by selling, or by offering and agreeing to sell, securities of Equity Funding Corporation of America for their clients on the basis of material, non-public inside information concerning allegations of fraud at Equity Funding obtained from Respondent Raymond L. Dirks and others without disclosing such inside information to purchasers, potential purchasers, or the investing public.

(2) During March of 1973, as more particularly found above, Respondent Raymond L. Dirks wilfully aided and abet-

ted violations of Section 17(a) of the Securities Act by Respondents mentioned in paragraph (1) next above and wilfully violated and wilfully aided and abetted violations by such Respondents of Section 10(b) of the Exchange Act of 1934 and Rule 10b-5 thereunder, through use of jurisdictional means, by receiving and obtaining and selectively disclosing to said Respondents and to others material, non-public inside information concerning allegations of fraud at Equity Funding.

III

THE PUBLIC INTEREST

In determining what sanctions, if any, it is appropriate to apply in the public interest, it is necessary for the Commission, among other factors, to ". . . weigh the effect of . . . action or inaction on the welfare of investors as a class and on standards of conduct in the securities business generally."[63]

It does not appear that any of the Respondents has been the subject of prior disciplinary action. The principals of the selling respondents, and the firms themselves, enjoy good reputations. All selling respondents have incurred substantial legal costs, some significantly greater than others, in connection with defending this proceeding, and in private litigation, including both individual suits and class actions. The Boston Company, parent of III and Bristol & Co., incurred some $3.5 million in legal and related costs as a result of its Equity Funding involvement, of which 45% was allocated to Bristol & Co. and the balance to other subsidiaries. Class actions in the United States District Court arising out of the Equity Funding

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[63] *Arthur Lipper Corporation*, Securities Exchange Act Release No. 11773 (October 24, 1975) 8 SEC Docket 273, 281. Although [*sic*] the reviewing Court in *Arthur Lipper Corp.* v. *S.E.C.*, 547 F.2d 171, 184-5 (2d Cir. 1976) reduced the Commission's sanctions on its view of the facts, it recognized that deterrence of others from violations is a ligitimate [*sic*] purpose in the imposition of sanctions.

situation were settled for $60 million, toward which certain of the selling respondents, including Dreyfus, contributed $4 million.

Certain respondents urge that they lost customers and business that they have never recovered, but proof that this resulted from their having traded Equity Funding securities is not adequately established.

The Boston Company, parent of III and Bristol & Co., has a new chief executive officer who, in his testimony at the hearing, conveyed an impression of special sensitivity to proper recognition of the public investors' rights in matters such as insider trading.

Dreyfus states in its brief, and this is accepted as established for the purpose of assessing sanctions, that it has introduced an improved and effective system of compliance, including procedures for making counsel readily available to persons in the firm having to make transaction decisions that could involve inside information problems.

As to Dreyfus, account is also taken of the fact that although it did not disclose to Goldman, Sachs, all of the material, inside information it received, or make overall legally effective disclosure, it did disclose a significant amount of inside information to Goldman, Sachs. While Dreyfus had no legal basis for assuming it had made proper disclosure, its failure to make full disclosure is perhaps more understandable in light of the partial disclosure that was made and of the overall circumstances involving its transaction.

The argument made by several respondents that no sanction should be applied because of the Division's effort at "selective enforcement" is not accepted. There is no basis in the record for concluding that the Division or the Commission improperly selected Respondents to be proceeded against while failing to include others equally culpable.

Respondent Dirks was less than candid in his testimony in this proceeding, particularly as respects the degree of his

alleged disbelief of the allegations of fraud at EFCA at various stages of his investigation. Moreover, in suggesting that his investigation and selective dissemination of the allegations of fraud at EFCA were just a part of his normal functions as an insurance company analyst, Dirks evidences a lack of appreciation for the fundamental purpose underlying the insider trading rule. And, as the findings indicate, Dirks was an indispensable and knowing actor in the violations committed by the selling respondents. Dirks's argument that he should be given credit for having "exposed" the EFCA fraud has already been discounted in the findings above, in view of his mixed motives.

Dirks urges that as a result of his Equity Funding investigation he was fired from his job and kept out of his profession for about a year. Although he so testified, at other points in the record it appears that he may have taken a year off to write a book concerning his exposé. At any rate, he has not had difficulty obtaining a number of employments in the securities industry since that time. Dirks also claims he was thwarted in his efforts to become a registered investment adviser by "threats" that an administrative proceeding would be immediately mounted against him if he applied for registration.

In overall terms, the record indicates that on the whole Dirks sustained less (if any) financial loss or loss of reputation as a result of his involvement with the Equity Funding matter than did the selling respondents. And, of equal significance, selling respondents appear to have learned more from the experience in terms of future caution than has Dirks.

Taking into account the nature and extent of the violations, mitigating circumstances, and the record as a whole, it is concluded that the sanctions ordered below both for remedial and deterrent purposes are necessary, appropriate and adequate in the public interest.

IV

ORDER

Accordingly, IT IS ORDERED as follows:

(1) Respondent Raymond L. Dirks is hereby suspended from association with a broker or dealer for a period of sixty days.

(2) Respondents The Boston Company Institutional Investors, Inc., John W. Bristol & Co., Inc., Manning & Napier, and Tomlin, Zimmerman & Parmelee, Inc. are hereby censured.

(3) The imposition of a sanction is not deemed to be necessary in the public interest in the case of Respondent The Dreyfus Corporation.

This order shall become effective in accordance with and subject to Rule 17(f) of the Commission's Rules of Practice, 17 CFR §201.17(f).

Pursuant to Rule 17(f), this initial decision shall become the final decision of the Commission as to each party that has not, within fifteen (15) days after service of this initial decision upon him or it, filed a petition for review of this initial decision pursuant to Rule 17(b), unless the Commission, pursuant to Rule 17(c), determines on its own initiative to review this initial decision as to him or it. If a party timely files a petition for review, or the Commission takes action to review as to a

party, the initial decision shall not become final with respect to that party.[64]

/s/ _____
David J. Markun
Administrative Law Judge

Washington, D.C.
September 1, 1978

[64] All proposed findings, conclusions, and supporting arguments of the parties have been considered. To the extent that the proposed findings and conclusions submitted by the parties, and the arguments made by them, are in accordance with the findings, conclusions and views stated herein they have been accepted, and to the extent they are inconsistent therewith they have been rejected. Certain proposed findings and conclusions have been omitted as not relevant or as not necessary to proper determination of the material issues presented. To the extent that the testimony of various witnesses is not in accord with the findings herein it is not credited.

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CLERK

No. 82-276

In the Supreme Court of the United States

OCTOBER TERM, 1982

RAYMOND L. DIRKS, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION,
RESPONDENT

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

EDWARD F. GREENE
General Counsel

PAUL GONSON
Solicitor

LARRY R. LAVOIE
Senior Special Counsel

WHITNEY ADAMS
Assistant General Counsel

RUTH E. EISENBERG
LAURA R. SINGER
Attorneys

Securities and Exchange Commission
Washington, D.C. 20549

QUESTIONS PRESENTED

1. Whether nonpublic information revealing that a publicly traded company has vastly overstated its reported assets and earnings is "material" inside information, when the information is specific, known to come from insider sources, and known to be substantially accurate.

2. Whether the view of the Commission and the court below that confidants ("tippees") of corporate insiders assume their insiders' duties to disclose material inside information prior to trading on the basis of such information is consistent with dictum regarding tippee liability in *Chiarella* v. *United States*, 445 U.S. 222 (1980).

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BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A-1-A-41) is reported at 681 F.2d 824. The opinion of the Securities and Exchange Commission (Pet. App. B-1-B-27) is reported at 21 SEC DOCKET 1401.

JURISDICTION

The judgment of the court of appeals (Pet. App. C-1-C-2) was entered on March 29, 1982. A petition for rehearing was denied on May 19, 1982 (Pet. App. C-3-C-5). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner Raymond L. Dirks is a professional securities analyst. In March 1973, petitioner was vice-president of a securities broker-dealer firm registered with the Commission under the Securities Exchange Act of 1934. He specialized in providing investment advice about insurance company stocks to institutional investors.

Equity Funding Corporation of America ("Equity Funding") was an insurance holding company. On March 28, 1973, the Commission stopped all trading in Equity Funding securities based upon evidence that the company had vastly overstated its reported assets and earnings. Shortly thereafter, Equity Funding filed for bankruptcy, and almost two-thirds of the insurance reportedly issued by the company was exposed as fictitious; thus, the information in the market in which the company's securities had been trading was grossly inaccurate.

2. On January 22, 1981, at the conclusion of a lengthy administrative proceeding, the Commission entered an order censuring petitioner [1] for selectively disseminating material nonpublic information concerning massive fraud within Equity Funding to institutional investors and their advisors.[2] Based upon this information, petitioner's tippees sold over $17

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[1] Censure is the mildest remedy available to the Commission in an administrative proceeding; it imposes no restrictions on a respondent's activities.

[2] The Commission's findings were based upon its independent review of a 13,000 page factual record in an adversary proceeding conducted by an administrative law judge (Pet. App. B-2). The Commission's decision affirmed the findings of the administrative law judge but reduced the sanction he would have imposed from a 60-day suspension from employment in the securities business to a censure (*id.* at B-2, B-26).

million of Equity Funding securities, mostly in trades on the New York Stock Exchange, just before the collapse of the company rendered those securities worthless. The Commission found that these sales violated antifraud provisions of the federal securities laws,[3] and that petitioner had willfully aided and abetted the violations.[4]

In particular, the Commission found that on March 6 and 7, 1973, petitioner was made privy to detailed information concerning the massive fraud within Equity Funding by Ronald Secrist, a former Equity Funding vice-president, who sought petitioner's assistance in publicly exposing the fraud (Pet. App. B-3-B-4). Mr. Secrist informed petitioner that at least one-third of the insurance reportedly issued by Equity Funding was fictitious, described in detail how top-echelon management had been able to conceal the fictitious nature of this insurance, and provided petitioner with names of other Equity Funding insiders who could corroborate the existence of the fraud (*ibid.*). Petitioner agreed to help Mr. Secrist, stating that he had contacts at the *Wall Street Journal* who would have the ability to expose the fraud publicly, provided that it could be substantiated (*ibid.*; J.A. 163-164; R. 463).[5]

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[3] Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5.

[4] The Commission found that petitioner acted with scienter in assisting his clients to violate the law (Pet. App. B-20-B-25), and the court of appeals affirmed this finding (*id.* at A-35-A-40).

[5] "J.A. ——" and "R. ——" refer to the joint appendix and certified record filed in the court of appeals.

During the week of March 12, 1973, before contacting the persons named by Mr. Secrist or law enforcement authorities, petitioner began to convey the information obtained from Mr. Secrist to a select group of institutional investors (Pet. App. B-5). He quickly ascertained the identities of clients that were interested in Equity Funding and began to contact them (Pet. App. B-5); he conveyed only a "soft story" about accounting irregularities at the company to those who he determined did not own Equity Funding securities.[6] One client to whom petitioner did reveal the fraud at that time, the Boston Company Institutional Investors, Inc. ("Boston"), sold $1.2 million of its clients' holdings of Equity Funding securities based upon this information alone (*ibid.*). Boston then directed $4,000 in commission business to petitioner's firm and repeatedly obtained further information from petitioner (Pet. App. B-5-B-6 & n.9; J.A. 1063).

The following week, on Monday, March 19, 1973, petitioner began to substantiate the key portions of Secrist's information (Pet. App. B-6). While Equity Funding's top management denied the existence of fraud,[7] six Equity Funding insiders to whom peti-

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[6] *In re Boston Co. Institutional Investors, Inc.*, [1978] Fed. Sec. L. Rep. (CCH) ¶ 81,705 at 80,842; *id.* at 80,835-36, 80,845. For example, the administrative law judge who presided over the trial proceedings found that, on March 26, 1973, Mr. Dirks answered inquiries about Equity Funding made by officials of Fidelity Management and Research, an advisor in Boston, "but he did not relate the fraud allegations to them, because he learned they did not own any [Equity Funding] stock." *Id.* at 80,845.

[7] Petitioner decided to confront Equity Funding's management after being advised by one of his tippees that he could get into serious trouble by selectively disclosing non-public

tioner had been directed by Mr. Secrist reported to petitioner detailed, often first-hand evidence of widespread fraud at the company (*id.* at B-9). One of them, Equity Funding's former controller, confessed to petitioner that he had falsified ledgers in 1970 to conceal the company's fictitious insurance, adding that he thought he would be " 'going to jail' " for his participation in the company's fraud (*id.* at B-6; J.A. 320). During the week, Mr. Dirks reported this information to a *Wall Street Journal* reporter, who commenced an independent investigation of the matter (Pet. App. B-7; J.A. 552-555, 946-947).

As he substantiated the fraud, petitioner continued privately to divulge its existence to clients and potential clients. On March 20, petitioner updated Boston, informing its officials of the controller's confession (Pet. App. B-6). The following day, Boston sold its clients' remaining holdings of Equity Funding securities for $7.5 million and promised to direct $25,000 in commission business to petitioner's firm (*id.* at B-6-B-7). Between Friday, March 23, and Monday, March 26, 1973, petitioner supplied the information to four other advisors of institutional investors, expressly stating to one, John W. Bristol & Co., that a halt in trading was imminent and that if he were in its position " 'he would sell the stock' " (Pet. App. B-9-B-11). On March 26, Bristol sold more than $8 million of Equity Funding securities; the other three advisors sold more than $1 million of the company's securities (*ibid.*).

Up to this time, petitioner had made no attempt to contact the New York Stock Exchange, the Commis-

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information about the company (Pet. App. B-17 n.33; J.A. 990) and that he should therefore confront the management with the allegations (J.A. 981).

sion or any other law enforcement authority. Meanwhile, the *Wall Street Journal* reporter to whom petitioner earlier had spoken had conducted an independent investigation and had arranged for a meeting with the Commission's staff to report the results of his own investigation.[8] At the reporter's urging, petitioner attended the meeting, which took place on March 27, 1973 (Pet. App. B-11).

During that meeting, the New York Stock Exchange halted trading in Equity Funding stock (*ibid.*; J.A. 566, 972-974). Based upon the information obtained from petitioner and others, on the next day, March 28, 1973, the Commission suspended all trading in Equity Funding securities and a week later filed an injunctive action against the company and several of its officials (*ibid.*; J.A. 929).

Based on these findings, the Commission rejected petitioner's contention that the information he had supplied to his clients was "merely rumors and unverified allegations" and not "material facts" within the antifraud provisions of the federal securities laws (Pet. App. B-14). The Commission found that the information that petitioner tipped to his clients concerning Equity Funding sharply contrasted with the information that was publicly available in the marketplace (*id.* at B-14-B-15, B-20-B-21). Petitioner's information was "specific and detailed," was from a known inside source, and, by March 23, 1973, had been repeatedly corroborated by "detailed, often first-hand" information from other Equity Funding

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[8] Although the reporter from the *Wall Street Journal* was not yet ready to publish a story about Equity Funding, he was so alarmed by the results of his investigation that he believed the Commission should be informed immediately (Pet. App. B-11; J.A. 121, 947-954).

insiders (*id.* at B-14-B-15, B-17). "Few disclosures," the Commission found, "could have had a greater impact on the quality of an investment, or on the stability of the market for it, and Dirks and his tippees clearly appreciated that fact" (*id.* at B-17). The Commission stressed that the information was "clearly" and "unquestionably" material during the period from March 23 to March 26 (*id.* at B-14-B-15), and that petitioner's censure was warranted on the basis of the more than $8 million of trades that he fostered during that brief period alone (*id.* at B-26 n.54).

The Commission also rejected petitioner's contention that, under this Court's holding in *Chiarella* v. *United States*, 445 U.S. 222 (1980), neither he nor his tippee-clients had a duty to disclose their inside information prior to selling Equity Funding securities (Pet. App. B-11-B-12, B-21 n.42). The Commission found *Chiarella* consistent with its interpretation that "corporate insiders" have a duty to disclose or abstain from trading in the securities of their corporation on the basis of material inside information and that "tippees," such as petitioner and his clients, "who receive non-public, material information from insiders become 'subject to the same duty as [the] insiders' " (Pet. App. B-11-B-12 & n.21, B-21 n.42, quoting *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237 (2d Cir. 1974)). The Commission found that, irrespective of any privilege they may have had to disclose Equity Funding's fraud, petitioner's insider sources had a duty not to profit from use of their information and that petitioner had "assumed" a similar duty "in dealing with them" (Pet. App. B-20-B-21 & n.42).

In view of mitigating circumstances, including petitioner's reporting of the fraud to the *Wall Street*

Journal and subsequently to the Commission, the Commission determined to impose only a censure against petitioner (Pet. App. B-26). The Commission noted that some sanction was warranted because, despite his efforts to assist Mr. Secrist in publicizing the fraud, petitioner had advised clients of the fraud privately so that they would be able to "trade on the information well before it would become public" (*id.* at B-26 n.52).

3. On March 29, 1982, the court of appeals (Wright, Tamm, and Robb, J.J.) entered a judgment without accompanying opinion denying, "for the reasons stated by the Commission in its opinion," petitioner's petition for review of the Commission's censure order (Pet. App. C-1-C-2).[9] Judge Tamm dissented from the judgment. On April 27, 1982, petitioner requested rehearing and suggested rehearing en banc.

On May 18, 1982, the court of appeals issued an opinion authored by Judge Wright (Pet. App. A-1-A-41). Judge Robb concurred in the result, and Judge Tamm dissented; neither filed a separate opinion. Judge Wright stated that petitioner's censure should be affirmed on the theory expressed by the Commission that petitioner and his tippees had assumed the "disclose-or-abstain" obligations of their insider sources (*id.* at A-15-A-27, citing *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, *supra*, 495 F.2d 228). Judge Wright added that, even apart from the obligations petitioner acquired under the Commission's theory, petitioner, as an employee of a broker-

[9] The judgment also stated "that petitioner breached his duty to the Commission and to the public not to misuse insider information and that he was compensated for so doing" (*ibid.*).

dealer, had ethical duties not to assist his "clients [in] dump[ing] fraudulent securities on an uninformed public" (Pet. App. A-3, A-27-A-31).

On May 19, 1982, petitioner's request for rehearing and for rehearing en banc was denied (Pet. App. C-3-C-5).

ARGUMENT

The decision of the court of appeals is correct and conflicts with no decision of this Court or any other court of appeals. Moreover, because the opinion of the court of appeals represents the views of a single judge and the court's decision appears to turn on a unique set of facts, the decision has limited precedential value. Accordingly, further review is unwarranted.

1. Contrary to petitioner's contention (Pet. 11-14, 21-24), the decision of the court of appeals does not raise issues of great importance regarding the proper role of securities analysts in our capital markets. This case does not involve an analyst's customary functions of collecting, distilling and analyzing publicly available information or contacting corporate management for " 'tidbits' " of immaterial information to fill in " 'interstices in analysis' " (Pet. App. B-18, quoting *In re Investors Management Co.*, 44 SEC 633, 646 (1971)). It involves the rare, perhaps once-in-a-lifetime case, in which an analyst is solicited by a corporate insider to assist in publicizing an unquestionably material story concerning a gigantic corporate fraud. Petitioner did not obtain information through routine research. He admitted that Mr. Secrist, his initial insider source, disclosed to him the entire story of the Equity Funding fraud and that his contacts with other insiders did not add " 'anything further to the allegations that Secrist had made, essentially' " (Pet. App. B-19). Because the decision in this case is an atypical one

which turns on its own "sensational facts" (Pet. App. A-2), it is both a decision of limited precedential value and a poor candidate for defining the proper role of the securities analyst.[10]

2. This case does not, as petitioner argues (Pet. 21), present the issue whether "unverified rumors" and "allegations" of fraud constitute "material facts" under *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976).[11] The Commission found, and the

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[10] Moreover, petitioner's fellow professionals have stated that use of inside information is unnecessary to their role of providing competent securities analysis. *Wall Street Analysts Agree: Raymond Dirks Blew It, The Commercial and Financial Chronicle*, April 19, 1973, at 1, 11; *New Guidelines on Inside Information, Financial Analysts Journal*, January/February 1974 at 20; W. Chatlos, *Financial Analyst's Handbook* 74-86 (Levine, ed., 1975). See also *New York Stock Exchange Company Manual* A-21 (1977) ("The competent analyst depends upon his professional skills and broad industry knowledge in making his evaluations and preparing his reports and does not need the type of inside information that could lead to unfairness in the marketplace"); W. Chatlos, *Financial Analyst's Handbook, supra*, 75 ("survival of the marketplace will depend, in no small way, on the curtailment of the frequency of abuse of inside information * * *"); *id.* at 74.

Accordingly, securities analysts have declared that use of inside information is an unethical professional practice. See Financial Analysts Federation, *Code of Ethics and Standards of Professional Conduct*, Standard II (as amended, May 9, 1982).

[11] Petitioner argues that in order to meet the materiality test in *TSC Industries, Inc.* v. *Northway, Inc.*, *supra*, 426 U.S. 438, information must not only be important to the reasonable investor but also sufficiently "verified" for one to have " 'full confidence' " in its accuracy (Pet. 21, quoting *Financial Industrial Fund, Inc.* v. *McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir.), cert. denied, 414 U.S. 874 (1973)). But the cases on which petitioner relies for this proposition

court of appeals affirmed, that during the period of March 23 through March 26, 1973, just before trading was halted, the information petitioner tipped "was far more than rumor and unverified allegations";[12] it was specific, detailed, from known inside sources and highly reliable (Pet. App. B-14-B-15; *id.* at A-34-A-35).[13]

The Commission predicated its censure of petitioner on his misconduct during the March 23-26 period

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(Pet. 21 & n.6) address the very different issue when important corporate information is "ripe" for public disclosure by a corporation—that is, when information is verified and there is no valid corporate purpose for its nondisclosure. The cases do not even suggest that corporate insiders and their privies are free to trade on information that their company withholds as not "ripe" for disclosure when that information nonetheless meets the *Northway* test of materiality. See Brudney, *Insiders, Outsiders and Informational Advantages under the Federal Securities Laws*, 93 Harv. L. Rev. 332, 336-337 (1979) ("Brudney").

[12] The Commission found, and the court of appeals affirmed (Pet. App. A-35, B-14-B-15 & n.30, B-21-B-22, C-2), that the "depth and scope of the information" available to petitioner was not comparable to the "rumors" about Equity Funding that were at issue in *Pachter* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 444 F. Supp. 417, 422 (E.D.N.Y.), aff'd mem., 594 F.2d 852 (2d Cir. 1978) and *Wiener* v. *Oppenheimer & Co.*, [1979] Fed. Sec. L. Rep. (CCH) ¶ 96,764 at 95,001 (S.D.N.Y. 1979). Accordingly, petitioner's reliance (Pet. 23) on these cases is misplaced.

[13] As noted by Judge Wright, as early as March 20th petitioner had "substantiated the key portions of Secrist's allegations" and by March 23rd "there is *no doubt* that the information he possessed and passed on to his clients had enough specificity to satisfy [Section 10(b)] and Rule 10b-5. He knew of specific blocks of false insurance, and he had a very detailed idea of how Equity Funding had gone about fooling its auditors and regulators" (Pet. App. A-8, A-34-A-35, emphasis supplied).

when the information was "obviously" and "unquestionably" material (Pet. App. B-14-B-15, B-26 n.54). Accordingly, petitioner's contention (Pet. 23) that not all of Mr. Secrist's original charges were ultimately proved true is irrelevant. "[D]uring the crucial March 23-26 period [petitioner's tips] related exclusively to charges *that he knew * * * were substantially true*" (Pet. App. A-34 n.24, emphasis supplied). Likewise irrelevant is petitioner's contention (Pet. 22) that the early reactions of his tippees lacked uniformity; the record demonstrates that those who were tipped during the March 23-26 period "tended to sell whatever Equity Funding stock they could" (Pet. App. A-34). Finally, the obvious materiality of the information during the critical period is not undercut, as petitioner suggests (Pet. 22-23), by the absence of any law enforcement action until March 27. Information may be "material" in the sense that it would be important to a reasonable investor and yet lack the substantiation needed to commence a law enforcement action. Moreover, not until March 27th when petitioner approached the Commission for the first time did the Commission obtain information comparable to that which petitioner possessed (Pet. App. B-11 n.18).

In any event, a finding of materiality, such as the Commission made here, requires "delicate assessments" of the inferences that a reasonable investor would draw from a particular set of facts and, therefore, is a matter "peculiarly * * * for the trier of fact." *TSC Industries, Inc.* v. *Northway, Inc., supra*, 426 U.S. at 450 (footnote omitted). Where, as here, a court of appeals finds that substantial evidence in the record supports such a finding by an agency (Pet. App. C-1-C-2), review by this Court is unwarranted.

Universal Camera Corp. v. *NLRB*, 340 U.S. 474, 487-492 (1951) (the question whether substantial evidence supports an agency's finding belongs to the court of appeals); *Graver Tank & Mfg. Co.* v. *Linde Air Products Co.*, 336 U.S. 271, 276 (1949) (concurrent findings of fact will not be disturbed).

3. Contrary to petitioner's contention (Pet. 14-21), the Commission's finding that petitioner assumed the "disclose-or-abstain" duties of his insider sources does not conflict with this Court's decision in *Chiarella* v. *United States*, 445 U.S. 222 (1980). Indeed, dictum in *Chiarella* reaffirmed traditional prohibitions against trading by insiders and their tippees on *inside* information—nonpublic information concerning the assets or earnings of a company.[14] *Chiarella* held only that a person incurs no general duty to disclose under Section 10(b) of the Securities Exchange Act of 1934 from his "mere possession of nonpublic *market* information"—that is, information generated in the securities markets about the supply and demand for particular securities. 445 U.S. at 231, 235 (emphasis supplied).[15]

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[14] *Chiarella* has been interpreted as leaving undisturbed traditional prohibitions against trading by insiders and their tippees on inside information. See *Elkind* v. *Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980); *Securities and Exchange Commission* v. *Lund*, [1981-1982] Fed. Sec. L. Rep. (CCH) ¶ 98,428 (C.D. Ca. 1982). See also *Feldman* v. *Simkins Industries, Inc.*, 679 F.2d 1299, 1304 (9th Cir. 1982) (discussing *Chiarella* holding); *Staffin* v. *Greenberg*, 672 F.2d 1196, 1202 (3rd Cir. 1982) (same); *O'Connor & Assoc.* v. *Dean Witter Reynolds, Inc.*, 529 F. Supp. 1179, 1187 (S.D.N.Y. 1981) (same).

[15] This Court emphasized that Chiarella was "not a corporate insider and he received no confidential information * * *" from the companies the shares of which he traded. 445 U.S. at 231.

In reaching its holding in *Chiarella*, this Court recognized that administrative and judicial decisions had established that tippees of corporate insiders can acquire the duties of their tippors under Section 10(b) to disclose material inside information before trading on the basis of such information. 445 U.S. 226-230. This Court reasoned that to recognize a similar general duty to disclose nonpublic market information, in effect completely prohibiting use of such information, would be inconsistent with the regulatory pattern of the Securities Exchange Act. 445 U.S. at 233-235. This Court concluded:

> We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic *market information*. The contrary result is without support in the legislative history of § 10(b) and would be inconsistent with the careful plan that Congress has enacted for regulation of the securities markets.

445 U.S. at 235 (emphasis supplied).

Neither this holding nor its underlying logic conflicts with the theory of tippee liability involved here. The Court made clear in *Chiarella* that the source of the information, a prospective tender-offeror, was, under the scheme of the Act, free itself to trade on the information (within certain limits) and also to disclose information about its prospective tender offer to selected institutional investors. 445 U.S. at 233-234. In *Chiarella*, thus, there was no disclosure duty to be inherited by tippees. Here, petitioner's sources, present and former corporate employees, were, whatever their obligation to disclose the fraud to proper authorities, under a duty not to trade on the information while it remained undisclosed. As we have al-

ready pointed out, this Court in *Chiarella* noted with favor decisions which had held that tippees may inherit such obligations of their insider sources either to disclose inside information or abstain from trading on the basis of it.

The discussion of tippee liability in footnote 12 of the *Chiarella* opinion does not, as petitioner argues (Pet. i, 18), purport to limit the circumstances in which a tippee can assume a disclose-or-abstain duty to those instances in which he receives inside information through the breach of an insider's fiduciary duty. The Court's careful notation that a tippee's disclosure obligation "has been viewed" as arising from his role as a participant after the fact in his insider's breach of duty (*ibid.*) negates any suggestion that the Court intended to foreclose other theories of tippee liability. This is confirmed by the Court's favorable reference in the same footnote to *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, *supra*, 495 F.2d at 237-238, a case in which the court of appeals found liable a tippee who acquired inside information properly rather than through a breach of an insider's duty.[16] This view of tippee liability is consistent with that espoused

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[16] Petitioner contends (Pet. 20-21) that the decision of the court of appeals in this case is "sharply at odds" with the decision of the Second Circuit in *Walton* v. *Morgan Stanley & Co.*, 623 F.2d 796 (1980). But *Walton* was a diversity case involving an interpretation of state law, not as the Second Circuit's decision in *Shapiro*, a case involving an interpetaton of the antifraud provisions of the federal securities laws. Accordingly, there is no need for this Court to review the present decision for consistency with *Walton*. See *Ruhlin* v. *New York Life Ins. Co.*, 304 U.S. 202, 206 (1938).

by courts,[17] commentators,[18] and the proposed *Federal Securities Code*.[19]

4. Contrary to petitioner's contention (Pet. 14-17), there is no reason for this Court to review Judge Wright's alternate theory that petitioner, as an employee of a broker-dealer firm registered with the Commission, had a special duty to disclose or abstain from trading. As demonstrated above, the Commission's theory, which was affirmed by the court of appeals, fully supports the censure that was entered against petitioner. Further, the Commission did not consider Judge Wright's alternate theory in its decision, nor did it present that theory to the court of appeals (Pet. 15-16). See *Securities and Exchange Commission* v. *Chenery Corp.*, 332 U.S. 194, 196 (1947).[20]

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[17] See, *e.g.*, *Feldman* v. *Simkins Industries, Inc.*, *supra*, 679 F.2d at 1304 (the test for "insider status is whether the person has *access* to confidential information intended to be available only for a corporate purpose and not for the personal benefit of anyone") (emphasis supplied).

[18] Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 Cal. L. Rev. 1, 30-31 (1982); Brudney, *supra*, 93 Harv. L. Rev. at 347-348 & n.82; Subcommittees of the ABA Section of Corporation, Banking and Business Law, Comment Letter on Material Nonpublic Information (Oct. 15, 1973), reprinted in BNA, *Securities Regulation & Law Report* No. 233, pp. D-5-D-6 (Jan. 1974).

[19] The ALI *Federal Securities Code* (Proposed Official Draft 1980) defines the term "insider" to include "any person" who acquires information from a present or former corporate official or employee with knowledge of its source. Section 1603(a), (b) and Comments 1 and 7.

[20] Petitioner speculates (Pet. 18 & n.4) that, because the judgment entered on March 29, 1982, articulated Judge Wright's alternative view, it is unclear whether the court of appeals intended to affirm on the basis of the Commission's

CONCLUSION

The petition for a writ of certiorari should be denied.*

Respectfully submitted,

EDWARD F. GREENE
General Counsel

PAUL GONSON
Solicitor

WHITNEY ADAMS
Assistant General Counsel

LARRY R. LAVOIE
Senior Special Counsel

RUTH E. EISENBERG
LAURA R. SINGER
Attorneys

Securities and Exchange Commission
Washington, D.C. 20549

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theory. Petitioner's speculation ignores, however, the explicit statement in the judgment that the petition for review was denied "for the reasons stated by the Commission in its opinion * * *" (Pet. App. C-2).

* The Solicitor General authorizes the filing of this brief. The Solicitor General is of the view that the holding of the court of appeals is in conflict with this Court's decision in *Chiarella* v. *United States*, 445 U.S. 222 (1980). The information about the ongoing criminal scheme, obtained by a former employee of Equity Funding and passed on to petitioner Dirks, was not "inside" information or any other form of "confidential" information. See *Roberts* v. *United States*, 445 U.S. 552, 557-558 (1980); compare *Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961). Petitioner Dirks was not under a

duty to disclose that information before trading with it or passing it on. He was subject to no fiduciary relationship with other traders (*Chiarella* v. *United States*, *supra*, 445 U.S. at 228), there was no element of misappropriation or other misconduct in obtaining or transmitting the information (*id.* at 239-245) (Burger, C.J., dissenting), and the information was "legally available to others" through the exercise of "diligence or acumen" (*id.* at 251-252 & n.2) (Blackmun, J., dissenting). In these circumstances, there is no basis for viewing petitioner's conduct as fraudulent under the federal securities laws. The Solicitor General also is of the view that the decisions of the SEC and the court of appeals have a potential adverse effect on federal criminal law enforcement.

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No. 82-276

In the Supreme Court of the United States

OCTOBER TERM, 1982

RAYMOND L. DIRKS, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

SUPPLEMENTAL BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

PAUL GONSON
Solicitor

LARRY R. LAVOIE
Senior Special Counsel

Securities and Exchange Commission
Washington, D.C. 20549

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SUPPLEMENTAL BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

The Commission files this supplemental brief to correct two significant misstatements of fact made in petitioner's reply brief.

1. Petitioner misstates the record in asserting twice (Reply Br. 7, emphasis supplied; *id.* at 9) that a Commission staff attorney argued before the Commission that "when Dirks learned of the allegations of fraud at Equity Funding he *should* have done 'nothing'." In fact, the transcript of the oral argument before the Commission shows that while the Commission's attorney said that petitioner "*could* have done nothing" about the evidence of fraud that he had obtained, he argued that petitioner "*should* have reported it to the New York Stock Exchange" (emphasis supplied):

> [SEC] COMMISSIONER KARMEL: Mr. Malawsky, what do you think Mr. Dirks should have done at this time?

> MR. MALAWSKY [SEC Attorney]: As a matter of law, what should he have done?
>
> COMMISSIONER KARMEL: Yes.
>
> MR. MALAWSKY: Mr. Dirks could have—first of all, he should not have tipped what he should have done, potentially he could have done nothing. If he wanted to follow up the investigation, he certainly could have done that. And we are not complaining at all that he engaged in and embarked upon an investigation. We are not asserting that he had an obligation and a duty to report, although under the New York Stock Exchange rules at that time, if he did deem this a rumor, he should have reported it to the New York Stock Exchange. He had that duty and obligation.

Transcript of Proceedings on June 13, 1979, at 35.

2. We also deem it necessary to answer petitioner's assertion (Reply Br. 5-6 n.2) that the Commission "grossly misstate[d]" the Administrative Law Judge's findings regarding petitioner's selective dissemination of information relating to the Equity Funding fraud. There can be no doubt, as we stated on page 4 of our brief in opposition, that the Administrative Law Judge found that petitioner disclosed evidence of the fraud to institutional investors after first determining that they owned Equity Funding securities.[1] In

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[1] *See, e.g.*, [1978] Fed. Sec. L. Rep. (CCH) para. 81,707 at 80,823, 80,840 (Dirks identified The Boston Company Institutional Investors, Inc., as a "likely holder[] of EFCA securities" before relating to it the fraud); *id.* at 80,840-41 ("Prior to relating any of the Secrist allegations, Dirks first ascertained that Institutional Capital did then own EFCA stock"); *id.* at 80,844 ("After Alsop indicated that Fiduciary held substantial EFCA securities, Dirks * * * related to him the substance of the[] allegations of fraud * * *"); *id.* at 80,845 ("Dirks was aware at the time that Lawton had that morning purchased a substantial block of EFCA"); *id.* at 80,846 ("Dirks conveyed briefly to an analyst at Morgan Guaranty the allegations of fraud at EFCA after learning that Morgan Guaranty had an interest in EFCA").

the interest of brevity, the Commission included in its brief in opposition only one example in which petitioner either conveyed a "soft story" about accounting irregularities or nothing at all to certain investors. In fact, the Administrative Law Judge identified three such instances.

First, he found that on March 22, 1973, petitioner had a conversation with The Dreyfus Corporation in which he

> mentioned nonrecurring gains in EFCA earnings and two or three other matters that might reflect adversely on EFCA's management or its future prospects, but none of which involved reports of bogus insurance * * *.
>
> On March 23 * * * Dirks initiated [a] call to Dreyfus because he had ascertained in the interim through Vicker's publication or somehow that Dreyfus clients had EFCA holdings. Dirks now told [Dreyfus] * * * of [the] bogus insurance * * *.

[1978] Fed. Sec. L. Rep. (CCH) para. 81,705 at 80,832.

Second, on March 20 and 22, 1973, petitioner indicated to Tomlin, Zimmerman and Parmelee, Inc., "that he had questions about a possible change in accounting for dividends to participating policyholders * * * which could have inflated EFCA's 1972 earnings" but he made "no mention of fictitious insurance or of fraud at EFCA or any of its subsidiaries in the course of [his] conversation[s]." *Id.* at 80,835, 80,836.[2]

Finally, on March 26, 1973, petitioner "called Fidelity Management and Research in Boston, but he did not relate the allegations to them, because he learned they did not own

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[2]Although the Administrative Law Judge made no finding as to petitioner's reason for doing so, he found that petitioner eventually disclosed the truth to Tomlin, Zimmerman and Parmelee, Inc., on March 26, 1973. *Id.* at 80,836-38.

EFCA stock." *Id.* at 80,845. Petitioner argues (Reply Br. 5 n.2) that he did not disclose the fraud to Fidelity Management and Research "because they expressed no interest in the company and could not be expected to follow up on the allegations." He testified during the Commission's investigation, however, that Fidelity "didn't own stock so I really didn't give [it] the story" (R. 1151).

CONCLUSION

The petition for a writ of certiorari should be denied.*

Respectfully submitted.

PAUL GONSON
Solicitor

LARRY R. LAVOIE
Senior Special Counsel

Securities and Exchange Commission
Washington, D.C. 20549

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*The Solicitor General authorizes the filing of this brief.

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SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITIONER'S REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

DAVID BONDERMAN
Counsel of Record
LAWRENCE A. SCHNEIDER
ERIC SUMMERGRAD
ARNOLD & PORTER
1200 New Hampshire Ave., N.W.
Washington, D.C. 20036
(202) 872-6700
Attorneys for Petitioner
Raymond L. Dirks

October 29, 1982

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Petitioner's Reply Brief In Support Of Petition For Writ Of Certiorari To The United States Court Of Appeals For The District Of Columbia Circuit

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1. The Solicitor General Agrees with Petitioner that the Decisions Below Are Wrong and Will Have an Adverse Effect on Federal Criminal Law Enforcement

It is undisputed that Petitioner Dirks, following up unverified allegations of a former employee, uncovered and helped make public a massive fraud at Equity Funding Corporation of America. As a result, twenty-two participants in the fraud were convicted of federal crimes and received sentences ranging up to eight years in jail, along with substantial fines. It is equally undisputed that a somnolent SEC had failed to uncover the fraud despite being given essentially the same leads as Dirks on several different occasions (once by a former member of its own staff) over a period of years.

The SEC's response to all this, approved by the Court of Appeals for the District of Columbia Circuit, was to sue

Dirks because some of the persons to whom he disclosed his ongoing investigation as he tried to publicize the allegations traded in Equity Funding stock.

Petitioner Dirks has set forth in his Petition for Writ of Certiorari the reasons why the decision of the Court of Appeals for the District of Columbia Circuit in this case raises issues of great importance to the proper functioning of the securities industry and to law enforcement, and conflicts with this Court's decision in *Chiarella* v. *United States*, 445 U.S. 222 (1980). The Solicitor General agrees with Petitioner.

Indeed, the most significant aspect of the brief filed by the Securities and Exchange Commission in Opposition to the Petition herein is that the Solicitor General not only has refused to sign the brief but has also taken the extraordinary step of stating that:

> "The Solicitor General is of the view that the holding of the court of appeals is in conflict with this Court's decision in *Chiarella* v. *United States*, 445 U.S. 222 (1980). The information about the ongoing criminal scheme, obtained by a former employee of Equity Funding and passed on to petitioner Dirks, was not 'inside' information or any other form of 'confidential' information. See *Roberts* v. *United States*, 445 U.S. 552, 557-558 (1980); compare *Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961). Petitioner Dirks was not under a duty to disclose that information before trading with it or passing it on. He was subject to no fiduciary relationship with other traders (*Chiarella* v. *United States, supra*, 445 U.S. at 228), there was no element of misappropriation or other misconduct in obtaining or transmitting the information (*id.* at 239-245) (Burger, C.J., dissenting), and the information was 'legally available to others' through the exercise of 'diligence or acumen' (*id.* at 251-252 & n.2) (Blackmun, J., dissenting). In these circumstances, there is no basis for viewing petitioner's conduct as

> fraudulent under the federal securities laws. The Solicitor General also is of the view that the decisions of the SEC and the court of appeals have a potential adverse effect on federal criminal law enforcement." (Opp. Br. at 17-18 n.*.)

The views of the Solicitor General that the position of the SEC and the decision below are not only wrong and inconsistent with this Court's ruling, but are potentially harmful to federal criminal law enforcement, amply demonstrate that this case should be reviewed by the Court.

2. The Decision of the Court Below Conflicts with the Decisions of This Court in *Chiarella* and of the Second Circuit

The SEC insists that the decision below does not conflict with this Court's decision in *Chiarella*. (Opp. Br. at 13) Yet the Solicitor General states in no uncertain terms that the D.C. Circuit decision conflicts not only with the majority opinion in *Chiarella*, but with the concurring and dissenting opinions in that case as well. (Opp. Br. at 17 n.*)

It is apparent that the holding below that Dirks acquired fiduciary duties to disclose or abstain when he legitimately acquired information and investigated allegations about corporate fraud constitutes a complete evisceration of *Chiarella* which should not be allowed to go unchecked. As Professor Easterbrook, commenting on this case, has observed, "when the release of information was not wrongful—and certainly the former employees of Equity Funding did no wrong in telling Dirks about the fraud—there is no justification for barring the use of the information." Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 S. Ct. Rev. 309, 338. Or to quote the Solicitor General, "in these circumstances there is no

basis for viewing petitioner's conduct as fraudulent under the federal securities laws." (Opp. Br. at 18 n.*)

Nor could there be a clearer conflict than that between the decision below and the Second Circuit's decision in *Walton* v. *Morgan Stanley & Co.*, 623 F.2d 796 (2d Cir. 1980). In *Walton*, the Second Circuit found that the investment banking firm breached no duty to a company that was not a client when it traded on inside information of that company.[1] Yet the D.C. Circuit has held that an employee of a broker-dealer has a special "ethical" duty "to the Commission and to the public" to disclose inside information or abstain from trading. (Opp. Br. at 16)

Finally, the SEC in effect suggests that this Court, future litigants, and—most importantly—all employees of broker-dealers should simply forget the Court of Appeals' novel imposition of this "ethical duty" as a legal requirement. But the judgment and opinion of the Court of Appeals cannot so easily be ignored. That decision will at a minimum be viewed as the law in the District of Columbia Circuit. Moreover, the SEC, having prevailed

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[1] Although the SEC seeks to distinguish *Walton* on the ground that it was a state law case, the Second Circuit expressly noted that the type of duty at issue was precisely the type of duty required under *Chiarella*. For this reason, *Walton* has been viewed as being in direct conflict with this case. *See* Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 Cal. L. Rev. 1, 30-32 (1982). It is worth noting in this context that the SEC's citation of *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974) (Opp. Br. at 15) does nothing to minimize the conflict between the Second and D.C. Circuits. In *Shapiro*, the underwriter had a fiduciary duty to its client company, as the SEC itself found in a related proceeding, and breached that duty in disclosing inside information of the company to its customers. *See also In re Investors Management Co.*, 44 S.E.C. 633, 645 (1971).

below, can be fully expected to use the case as a justification for its own nationwide prosecutorial decisions. Accordingly, if allowed to stand, the case will have mischievous effects upon the securities industry for years to come.

3. This Is an Important Case with Far-reaching Consequences for the Securities Industry and Federal Law Enforcement, and Should Be Reviewed

In light of the clear conflict with *Chiarella* and with the Second Circuit, the SEC is compelled to rely primarily upon the argument that this is a "once-in-a-lifetime" case which does not involve the sort of "routine research" that securities analysts engage in, and therefore does not warrant review. (Opp. Br. at 9)[2] The information that

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[2] It should be noted that the SEC's arguments on "materiality" (Opp. Br. at 10-13) fail to address squarely the question whether unverified allegations of fraud vigorously denied by management—some of which turn out to be true and some of which do not—are nonetheless material "facts" under the securities laws. *See* Petition at 21-25.

The SEC also grossly misstates the findings below. For example, the SEC incorrectly states that Dirks conveyed only a "soft" story about accounting irregularities to those who he determined did not own Equity Funding securities. (Opp. Br. at 4 & n.6) There is no support at all in the record for this. The Administrative Law Judge did not find that Dirks told a "soft" story to Fidelity Management and Research on March 26. In fact the testimony was undisputed that Dirks told them nothing at all about Equity Funding, because they expressed no interest in the company and could not be expected to follow up on the allegations. (*In re Boston Company Institutional Investors, Inc.*, slip opinion, at 101; [1978] Fed. Sec. L. Rep. (CCH) ¶ 81,705, at 80,845.) The only instance where the Administrative Law Judge found that Dirks conveyed a "soft" story involved a

Dirks received about a fraud of perhaps unparalleled magnitude may not have been "routine," but as the testimony made clear, receipt of this type of allegation is far from uncommon. (J.A. 940-41; R. 4507, 4509, 8680-81) On the contrary, because it is logical for an employee with such information to turn to an analyst who has been following an industry and who is known within that industry, securities analysts all too frequently receive information from corporate employees about criminal, or at least questionable, corporate activities.

For this reason, the community of analysts has certainly not viewed Dirks' situation as unique. Indeed, when the SEC proceeding was initiated against Dirks, the general counsel of the Financial Analysts Federation stated that the case "will have important ramifications relating to analysts' duties and responsibilities and the legal framework in which they are to carry out their professional occupation." Gillis, *Securities Law and Regulation—Equity Funding Revisited*, Fin. Analysts J. 10, 11 (March-April 1977). He went on to note that "[t]he 'bottom line' for analysts, is, of course, the legal and practical impact of the Equity Funding litigation on their ability to perform their vital professional functions." *Id.* at 12.

Under the decision below, an analyst who receives allegations of fraud is placed in an impossible position which will discourage analysts from investigating such allegations. He can ignore the allegations, perhaps allow-

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conversation early in Dirks' investigation with a firm that *did* own Equity Funding stock. A few days later Dirks conveyed the full allegations to that firm. (*In re Boston Company Institutional Investors, Inc., et al.*, slip opinion, at 89, 95-96, 101; [1978] Fed. Sec. L. Rep. (CCH) ¶ 81,705, at 80,842, 80,844, 80,845.)

ing his clients to be further defrauded and violating the duty he owes to them. He can report the allegations to the regulatory agencies and do nothing more, a course of dubious efficacy in a situation such as Equity Funding where, as Dirks had been told, the allegations had already been reported to the regulators over a period of years and they had failed to act. Or he can do what Dirks did: attempt to publicize the situation in the only way open to analysts, by informing the press and other members of the securities industry, and thereby risk prosecution.

Thus, as *The Wall Street Journal* concluded from discussions of this case with members of the investment community shortly after the Initial Decision in this case was announced, "the analyst and investment firm appear caught between a rock and a hard place." Lynch, *Security Analysis and the Law, The Wall Street Journal*, at 22:4 (Sept. 15, 1978). The likely result will be that analysts will indeed follow the counsel of the SEC's attorney who at oral argument before the Commission baldly stated that when Dirks learned of the allegations of fraud at Equity Funding he should have done "nothing." The effect will be to shield companies from any independent probing that might uncover misconduct.

The SEC contends that analysts do not need the type of information received by Petitioner on the ground that financial analysts have disclaimed the need for "inside information." (Opp. Br. at 10 n.10) Of course, analysts have no need for "inside" information—information relevant to a corporate purpose—since such information can normally be expected ultimately to be disclosed to the public or reflected in the company's financial statements. But allegations about criminal fraud denied by manage-

ment are not "inside information"[3] and will *never* be publicized by the company or reflected in the company's financial statements. An analyst cannot provide a meaningful evaluation of a company if he relies only on statements by management, and insists on shielding himself from information about possible fraud. As one attorney quoted in the *Journal* article put it, "[p]erhaps without realizing it, the SEC is on a course of stifling the accumulation of information that keeps management honest."

It is, therefore, apparent that encouraging receipt of such information by analysts, and allowing recipients to disseminate it to others in the market, has important public benefits. As numerous commentators have correctly pointed out, it was only Dirks' action in spreading the story through the market and the reaction of the market to the story that led to the ultimate awakening of the regulatory agencies to the fact that something was wrong at Equity Funding. *See* H. Kripke, *The SEC and Corporate Disclosure: Regulation in Search of a Purpose*

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[3] Throughout its brief, the SEC persists in improperly labeling what Dirks received as "inside" information. (*E.g.*, Opp. Br. at 13 and 10 n. 10) But as the Solicitor General unequivocally points out, the information Dirks obtained "was not 'inside' information or any other form of 'confidential' information." (Opp. Br. at 17 n.*)

It is well established that inside information is "confidential information intended to be available only for a corporate purpose and not for the personal benefit of anyone." *Feldman* v. *Simkins Industries, Inc.*, 679 F.2d 1299, 1304 (9th Cir. 1982); *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961). As one commentator on this case has observed, "[i]nformation relating to a gigantic corporate fraud upon others can scarcely be considered a corporate asset or as having a valid corporate purpose." Heller, *Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" versus Economic Theory*, 37 Bus. Law. 517, 548 (1982).

295 (1979); Heller, *Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" Versus Economic Theory, supra*, at 549-50; Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information, supra*, at 337. As noted, the result was the end of the fraud and the conviction of the perpetrators.

It is these very benefits of Dirks' actions, and the chilling effect the decision below will have on others in his position, that have prompted the Solicitor General to warn that the decisions below will have a potential adverse effect on federal criminal law enforcement. (Opp. Br. at 18 n.*.) If the decision below is not reversed, and if it is not made clear to analysts and others who may receive information of possible corporate crimes that they may investigate and disseminate and share that information, those who receive such information will do what the SEC staff recommended Dirks should have done—"nothing"—and the SEC's claim that this is a "once-in-a-lifetime case" will unfortunately become a self-fulfilling prophecy.

CONCLUSION

For the foregoing reasons, and for the reasons stated in the Petition, the Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

DAVID BONDERMAN
Counsel of Record
LAWRENCE A. SCHNEIDER
ERIC SUMMERGRAD

ARNOLD & PORTER
1200 New Hampshire Ave., N.W.
Washington, D.C. 20036
(202) 872-6700
Attorneys for Petitioner
Raymond L. Dirks

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IN THE

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OCTOBER TERM, 1982

RAYMOND L. DIRKS,

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SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The District Of Columbia Circuit

BRIEF FOR PETITIONER RAYMOND L. DIRKS

DAVID BONDERMAN
Counsel of Record
LAWRENCE A. SCHNEIDER
ERIC SUMMERGRAD
ARNOLD & PORTER
1200 New Hampshire Ave., N.W.
Washington, D.C. 20036
(202) 872-6700
Attorneys for Petitioner
Raymond L. Dirks

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QUESTIONS PRESENTED

Did the Court of Appeals err in holding liable under the antifraud provisions of the securities laws an analyst—who repeated allegations of corporate fraud made by several former and one present company employees, but denied by management, to many persons, some of whom later sold stock on the open market without disclosing the allegations—on the theory that:

(1) Under *Chiarella* v. *United States*, 445 U.S. 222 (1980), unverified allegations of fraud made by insiders necessarily carry with them a duty not to repeat the allegations to persons who may sell on the open market even if the analyst himself neither has any preexisting fiduciary duty nor obtains the allegations through any breach of an insider's fiduciary duty?

(2) Employees of a registered broker-dealer are "required to meet a high standard of ethical behavior" and therefore automatically have "a duty to the [Securities and Exchange] Commission and the [general] public" that satisfies the fiduciary duty requirement of *Chiarella* v. *United States*, *supra*?

(3) Unverified allegations of fraud vigorously denied by management are nonetheless "material facts" under the securities laws and *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976)?

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IN THE

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OCTOBER TERM, 1982

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On Writ Of Certiorari
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BRIEF FOR PETITIONER RAYMOND L. DIRKS

OPINIONS BELOW

The March 29, 1982 judgment of the Court of Appeals is not reported; it is reprinted in the Appendix to the Petition for a Writ of Certiorari at page C-1. The May 18, 1982 opinion of the Court of Appeals is reported at 681 F.2d 824 and is reprinted in the Appendix to the Petition for a Writ of Certiorari beginning at page A-1. The opinion of the Securities and Exchange Commission is reported at 21 S.E.C. Docket 1401, and is reprinted in the Appendix to the Petition for a Writ of Certiorari beginning at page B-1. The Initial Decision of Administrative Law Judge David Markun is reported unofficially in *In re Boston Company Institutional Investors, Inc., et al.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,705, and is reprinted in the Joint Appendix beginning at page 173.

JURISDICTION

The judgment of a divided panel of the Court of Appeals (Judge Tamm, dissenting) was entered on March 29, 1982. On May 18, 1982 Judge Wright filed an opinion in support of the judgment. Judge Robb concurred in the result only. Judge Tamm dissented. A timely Petition for Rehearing and Suggestion for Rehearing *En Banc*, filed on April 27, 1982, was denied on May 19, 1982. A timely petition for a writ of certiorari was filed on August 17, 1982 and was granted on November 15, 1982. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS

This case involves Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a); Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b); and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5. The provisions of these statutes and the regulation are set forth in the Appendix to the Petition for a Writ of Certiorari beginning at page D-1.

STATEMENT OF THE CASE

I. The Proceedings Below

Petitioner Raymond L. Dirks is a professional investment analyst. It is undisputed that in March 1973 Petitioner Dirks, following up unverified allegations of a former employee, uncovered and helped disclose to the public a massive fraud involving, among other things, the creation of fictitious insurance policies at Equity Funding Corporation of America ("Equity Funding" or "EFCA"), which was a major insurance holding company. As a result, twenty-two participants in the fraud were convicted of federal crimes and received sentences ranging up to eight years in jail, along with substantial fines. (*See* Division Ex. 80B, J.A. 149-53, R. 6594, 6595).[1]

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[1] The following abbreviations are used: R. = Record; I.D. = Initial Decision; Ex. = Exhibit during SEC administrative proceedings; J.A. = Joint Appendix; Pet. App. = Appendix to Petition for Writ of Certiorari.

It is also undisputed that a somnolent SEC had failed to uncover the fraud despite being given essentially the same leads as Dirks on several different occasions (once by a former member of its own staff) over a period of years.

Dirks, however, who was at the time employed as a securities analyst for the Wall Street firm of Delafield Childs, Inc., investigated these allegations himself and also attempted to have them investigated and publicized by *The Wall Street Journal*. In the course of his investigation, Dirks told many members of the investment community about the allegations of fraud. While most of these people discounted the unconfirmed allegations and some even bought Equity Funding stock after hearing them, others sold stock on the open market without disclosing the allegations. Neither Dirks nor his firm owned or traded any Equity Funding stock. (Dirks Ex. D, J.A. 154, R. 1806, 1956)

The SEC's response to these events was to charge Dirks with having violated and aided and abetted violations of Section 10(b), Rule 10b-5, and Section 17(a) of the securities laws when he repeated the allegations of fraud to members of the investment community who later sold their Equity Funding stock. Five sellers of Equity Funding securities were also named as respondents in the SEC administrative proceedings: The Boston Company Institutional Investors, Inc., The Dreyfus Corporation, John W. Bristol & Co., Tomlin, Zimmerman and Parmalee, Inc., and Manning and Napier.

Administrative Law Judge David Markun, in an Initial Decision rendered on September 1, 1978, found violations of the securities laws as alleged by the Division of Enforcement. He censured four of the trading respondents, imposed no sanction on the fifth, and recommended that Dirks be suspended from associating with a broker or dealer for a period of 60 days.

Dirks filed a timely petition for review of the Initial Decision with the Commission.[2] In response to Dirks' filing his petition

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[2] None of the trading respondents sought review of the ALJ's decision.

for review, the Division of Enforcement filed its own petition seeking to increase the sanctions imposed on Dirks.

The Commission rendered its Opinion on January 22, 1981. The Commission found that Dirks had aided and abetted violations of Section 17(a) and Rule 10b-5, but rejected the claim that Dirks had directly violated Rule 10b-5. The Commission also rejected the Division's request for increased sanctions. Recognizing that Dirks played "an important role in bringing EFCA's massive fraud to light," that Dirks "reported the fraud allegations to EFCA's auditors and sought to have the information published in *The Wall Street Journal*," and that in twenty years as an analyst Dirks had an "unblemished" record, the Commission reduced the sanction imposed by the Administrative Law Judge to a censure. (Pet. App. B-26)

On Petition for Review of the SEC's decision, a split panel of the Court of Appeals for the District of Columbia Circuit (Judge Tamm dissenting) issued a three-paragraph judgment on March 29, 1982, denying the Petition. The holding of this judgment was that:

> "The record in this case fully supports the Commission's findings that petitioner breached his duty to the Commission and to the public not to misuse insider information and that he was compensated for so doing. The record also assures us that the other findings of the Commission are not clearly erroneous and that the Commission's conclusions are solidly based in law." (Pet. App. C-1)

The court issued its judgment pursuant to local rule 13(c), which permits the court to render decisions without opinion where "the issues occasion no need therefor." A Petition for Rehearing and Suggestion for Rehearing *En Banc* was filed by petitioner on April 27, 1982, in which it was suggested that at the very least this was a case in which the novel issues raised warranted an opinion. The Petition for Rehearing was denied on May 19, 1982. (Pet. App. C-3 to C-5) On the previous day, however, May 18, 1982, the court issued a 41-page opinion by Judge Wright in support of the judgment. Judge Robb concurred in the result only. Judge Tamm dissented.

Judge Wright noted in his opinion that this case involves "both sensational facts and difficult issues of law and policy." (Pet. App. A-2) Judge Wright observed that investment analysts can play an important independent role in ferreting out corporate fraud and conceded that "[l]argely thanks to Dirks one of the most infamous frauds in recent memory was uncovered and exposed, while the record shows that the SEC repeatedly missed opportunities to investigate Equity Funding." (Pet. App. A-3) Judge Wright also observed that the threat of liability under the antifraud provisions of the securities laws may impede such investigations in the future. (Pet. App. A-3)

Nevertheless, Judge Wright found that Dirks had breached a legal duty of disclosure that he owed "to the SEC and to the public" solely because he was an investment analyst employed by a broker-dealer, and as a member of the securities industry was therefore "required to meet a high standard of ethical behavior." (Pet. App. A-27 to A-31) Judge Wright found that this duty to disclose was "created by the ethical standard that applies to broker-dealers" and that Dirks, in "failing to report promptly what he knew" to the SEC and the public, breached this duty. (Pet. App. A-29, A-31)

Judge Wright also found that since Dirks had heard the allegations about fraud at Equity Funding from former employees and one present employee of Equity Funding, he was a "tippee" of corporate insiders. Because both federal and relevant state law require the disclosure of fraudulent management activities, both the SEC and Judge Wright conceded that these "insiders," in disclosing the alleged fraud to Dirks, had not breached any fiduciary duty. (Pet. App. A-23 to A-25) Moreover, it was undisputed that Dirks himself was a stranger with no preexisting fiduciary duty to those who sold or bought Equity Funding stock. Nevertheless, Judge Wright found that Dirks had automatically acquired a fiduciary duty to "disclose or refrain" from trading on information acquired from the corporate "insiders" and that he breached that duty when he repeated the allegations to others, some of whom later sold Equity Funding stock.

Finally, Judge Wright found that the information in Dirks' possession constituted "material facts" for purposes of the securities laws, even though that information consisted of unverified allegations that did not come "from a source whose word would not be doubted," and were vigorously denied by management. (Pet. App. A-34 to A-35)

II. Summary Of Facts

The underlying facts in this case are largely undisputed. From the middle 1960s through the early 1970s, Equity Funding was regarded by the Wall Street investment community as a highly attractive "growth" company. In November 1971, the Los Angeles regional office of the Securities and Exchange Commission was told by a former Commission staff member that Equity Funding's controller was making allegations of fraud at the company, specifically that Equity Funding was overstating the amount of insurance in force by placing phony policies on its books. The SEC conducted an investigation, rejected an offer by the then former controller to provide information about substantial fraud at Equity Funding in exchange for immunity, found no incriminating evidence and closed its investigation. (J.A. 100-14)

On the morning of March 7, 1973, Ronald Secrist, a former employee of two of Equity Funding's life insurance subsidiaries, met with the New York Insurance Department and made allegations of fraud at Equity Funding in some detail, primarily to the effect that Equity Funding had phony policies on its books and that these policies were being sold to reinsurers as though they were real. (I.D. 138, J.A. 272; R. 376-81; J.A. 28) These allegations were relayed to the California Department of Insurance,[3] which in turn passed them on to the SEC on March 9, 1973. The SEC Los Angeles regional staff

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[3] The New York Insurance Department took no other action except for sending a memorandum to the SEC on March 21 and to the New Jersey Insurance Department (which had jurisdiction over one of Equity Funding's subsidiaries) on March 20.

reported that they had previously heard similar allegations by disgruntled employees which did not prove out and recommended that any inspection of Equity Funding operations be delayed until the next year when more personnel would be available. The SEC took no action on the allegations. (J.A. 91-98; Boston Company III Exhibit HHH, J.A. 171-72, R. 7702, 7717) A number of state insurance departments did subsequently commence an intensive audit, but during the relevant time period found no evidence of wrongdoing.

However, also on March 7, 1973, Secrist conveyed the same allegations to Petitioner Dirks, who was a highly respected securities analyst specializing in the insurance industry, and who had a reputation for conducting aggressive and independent investigations of the companies he reported on. (Pet. App. B-3) Secrist told Dirks that he had recently left an Equity Funding subsidiary, Bankers National Life Insurance Co., in protest over the way it was operated, and that there was substantial financial manipulation occurring at Bankers Life. (J.A. 31) (In fact, it subsequently turned out that there was no substantial wrongdoing at Bankers Life and that Secrist had not resigned in protest but had been fired.)

With respect to another Equity Funding subsidiary, Equity Funding Life Insurance Company of America ("EFLIC"), where Secrist had been employed several years earlier, Secrist made essentially the following allegations:

—in 1970, EFLIC had embarked on a program of selling totally fictitious life insurance policies to reinsurance companies, and one-third of EFLIC's insurance in force was fake (I.D. 75-76, J.A. 226-27; R. 219-24, 503-07);

—fictitious death certificates were created in order to collect proceeds of these policies from reinsurers (R. 232-33, 480-81; J.A. 31-32; R. 507, 532-33, 554, 1801);

—in order to reflect the receipt of premiums, EFLIC had printed its own bank statements, showing false deposits, and counterfeited certificates of deposit (I.D. 77, J.A. 227-28; R. 230);

—Equity Funding's real assets amounted to $10,000,000 rather than the reported $250,000,000 to $500,000,000 (R. 537);

—Equity Funding was selling limited partnerships in phony apartment houses (R. 245-46);

—leading Equity Funding officials had sold much of their Equity Funding stock in the previous six months and each had cash and a passport, ready to flee the country at a moment's notice (I.D. 78, J.A. 228; R. 541-42);

—Equity Funding had connections with the Mafia and would obtain contracts on people's lives if they caused trouble (I.D. 77, J.A. 228; R. 493);

—Haskins & Sells, EFLIC's former auditors, had become suspicious of EFLIC and had dropped the account (I.D. 77, J.A. 228; R. 510-11).

It ultimately turned out, although Dirks did not know it at the time, that the first three allegations were essentially correct and the remainder false.

These allegations were, on their face, improbable because the scheme alleged by Secrist would have required Equity Funding to carry out a massive fraud under the noses of three major accounting firms it had used as auditors, the SEC, the New York Stock Exchange, three or four state insurance commissions that regulated Equity Funding's operations, and various prestigious brokerage firms and banks.

Dirks nonetheless decided to investigate the allegations. Dirks understood that Secrist was highly reluctant to approach the SEC or other regulatory agencies since other Equity Funding employees had in the past gone to the agencies with this story, with no result other than word getting back to Equity Funding about the employees' actions.[4] (J.A. 22-23,

[4] Dirks did not know until March 19 that Secrist had gone to the New York State Insurance Department. (I.D. 84, J.A. 232; J.A. 50-51)

36-37, 66-67) Accordingly, Dirks and Secrist agreed not to approach the SEC at that time.[5] (J.A. 66-67)

Dirks instead asked for and received Secrist's permission to talk to *The Wall Street Journal*. (J.A. 21-22, 37-38) On March 12, Dirks telephoned Herb Lawson, San Francisco bureau chief of the *Journal*, whom Dirks knew, did not reach him, and left a message. (J.A. 47-48) As described below, Dirks was eventually put in touch with the *Journal's* Los Angeles bureau chief, William Blundell, with whom, as Judge Wright found, "he was also in touch regularly," and whom he "kept . . . up to date on the progress of the investigation and badgered . . . to write a story for *The Wall Street Journal* on the allegations of fraud at Equity Funding." (Pet. App. A-9)

On March 12 Dirks also called Stanley Goldblum, president of Equity Funding, who invited him to visit Equity Funding's offices in Los Angeles two weeks later. Dirks in fact decided on the evening of March 19 to visit Los Angeles immediately, in order to see if he could confirm or refute Secrist's allegations as quickly as possible.

On March 21, Dirks spent the day at Equity Funding with Goldblum and Fred Levin, Equity Funding's Executive Vice President, as well as with other employees. Dirks was told that insurance examiners from three states had found nothing wrong at the company (R. 807-10, 812-15, 1280-87, 1289-90, 8565), and was also shown details of the company's reinsurance arrangements and sales policies that contradicted Secrist's

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[5] Dirks was also reluctant to approach the SEC because of his own prior experience with the SEC staff. Dirks had previously gone to the SEC with information of insider trading at ITT. Although the staff promised to keep Dirks' name, and those of his sources—some of whom were clients—confidential, the staff told Dirks' clients of his meeting with the SEC and of the fact that he had named them as sources. As a result, Dirks lost business, lost standing in the Wall Street community, and was unenthusiastic about the behavior of the Commission's staff. (J.A. 66-67; Boston Company III Ex. JJJ, p. 90, R. 8264, 8390)

allegations. At the end of his visit, Dirks told Levin he did not believe the allegations and thought Secrist was a disgruntled ex-employee. (R. 977-80, 1287, 1292-97, 1301-09, 1328-32, 1879-80, 8472, 8474)

During this same time period Dirks also met with various former and current Equity Funding employees whom Secrist said could corroborate his story. The two principal sources were Patrick Hopper, a former Equity Funding vice president, and Frank Majerus, another former employee. Hopper told Dirks that Secrist had been fired and that there was no Mafia connection at Equity Funding. Hopper also said that he had heard these allegations from Secrist before, and that Secrist had a tendency to exaggerate and imagine things. Hopper nonetheless said that he tended to believe some of the allegations, although he had no proof of them, had never spoken to anyone who had direct knowledge of them, and did not believe Secrist had any real evidence. (R. 785-89, 874-76, 1270-73) Majerus told Dirks that he had been involved in activities in 1970 that he believed related to inflating insurance in force figures, but that he had no knowledge of the company's current practices. (R. 1276-77, 1607)

Dirks' other sources likewise provided no firm corroboration of Secrist's story. One of them, Gene Thibideau, said he thought there was phony insurance as a "one shot deal" which was "gone and buried" in 1970. (R. 994-96, 999-1002, 1352-53) Two others, Peter Ronchetti and Brian Tickler, thought that Equity Funding had been putting phony insurance policies on its books in 1971 but had no knowledge of Equity Funding's practices thereafter. (R. 1002-03, 1004-06, 1012-13, 1025, 1088-91, 1092-96, 1101-02, 1106, 1359-61) Donald Goff, the one current employee with whom Dirks spoke, said that his knowledge was not current, but he believed that Equity Funding had in the past inflated its insurance in force figures. (R. 1012-13, 1028-31, 1039; Division Ex. 4, R. 315, 317)

Dirks had reached Herb Lawson of the *Journal* on March 19, and had related to him Secrist's allegations. Lawson told Dirks that he was too busy to look into the situation because he had to

attend an annual (*i.e.*, routine) meeting of the Bank of America, but that he might refer the matter to the *Journal's* Los Angeles office. (J.A. 48-50)

On March 21, Dirks arranged to meet with William Blundell, Los Angeles bureau chief of the *Journal*. Dirks related to Blundell the Secrist allegations in detail and gave Blundell the names of additional people with whom he had talked or whom Secrist had said knew something about the fraud. (J.A. 52-54, 119-22) Blundell thought the allegations were "laughable" or at least "terribly unlikely," and told Dirks he could not write a story based on them because they were "flat out rumors." (J.A. 54, 122-26, 127-28, 136-37) Blundell did not think the rumors were of sufficient weight to bring to the attention of the SEC. (J.A. 128-29) Blundell began his own investigation on March 21. Blundell conducted a ten day investigation (J.A. 130), during which he talked to Secrist, additional sources given him by Dirks, and others. (J.A. 16-17, 61-62, 131)

Between March 23 and 26 Dirks called Blundell several times to inquire if he had enough information yet to publish a story. Even though Blundell had talked to numerous sources given him by Dirks and Secrist, he told Dirks throughout this period that he did not have sufficient information to justify publishing a story. (J.A. 55-56, 59-62, 131, 136-37) In fact, Blundell testified that he did not feel he could publish a story until the evening of March 30 (J.A. 130), which was after the first hard evidence of fraud at Equity Funding had been uncovered and well after trading in the company's securities was suspended. The *Journal* did not publish a story until April 2.

Dirks also sought to have Equity Funding's present and former auditors look into these allegations. On March 24 Dirks met with the partner in charge of the Equity Funding account at Seidman & Seidman, its then current auditors. Dirks related Secrist's allegations and gave the partner a copy of his notes from his meeting with Secrist. The partner turned the notes over to Equity Funding and took no other action. (J.A. 45, 56-57, 57-58; R. 7879-81) That same day Dirks met with the Haskins & Sells partner in charge of the EFLIC account until

1971. This partner said he had never heard any allegations of impropriety at the company and did not understand how it could have possibly occurred during his tenure as auditor. (J.A. 43-44, 56-59) Neither auditor notified any regulatory agency of the allegations.

Dirks did not himself (nor did his company) trade in any capacity in Equity Funding stock. In the course of his investigation Dirks did, however, speak with certain members of the investment community in an attempt to determine if the Secrist allegations could have any substance. Furthermore, as Dirks' investigation proceeded, he took calls from various persons within the community who were seeking to find out what he knew about Equity Funding. Dirks spoke with anyone who sought to contact him and conveyed the substance of what he had heard, including any information which tended to undercut the allegations. As Judge Wright found, "[o]n all occasions Dirks candidly discussed the status of his investigation with anyone who asked." (Pet. App. A-7)

While some of the people Dirks spoke to about the allegations sold their Equity Funding stock, they did not necessarily believe the allegations Dirks related to them, but did believe that the circulation of these rumors would depress the price of Equity Funding stock.[6] Even more importantly, these people represented only a small portion of the investment professionals who heard the allegations about Equity Funding. The record discloses that numerous other individuals and firms heard the allegations, from Dirks or otherwise (*see, e.g.*, J.A. 64-66), and either held their Equity Funding stock, recommended that others hold or buy the stock, or in fact purchased large amounts

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[6] For example, while Boston Company Institutional Investors, Inc. ("III"), one of the trading respondents below, eventually decided to sell its Equity Funding stock, Gerry Zukowski of III told Dirks on March 21 that this was because of the stock's declining market position, and even though he did not believe Secrist's allegations. (R. 803-06, 817, 821, 1457-58)

of additional stock, believing the price to be artificially low due to unfounded rumors. (*See, e.g.*, R. 1392-94, 1402-03, 1794-96, 1801, 8486-88, 8563-64; Division Exs. 42, R. 3378, 3406, and 43, R. 2379, 3422)

During this time, the various regulatory agencies charged with investigating and reporting corporate wrongdoing, including the SEC, heard the various allegations but either failed to act or, if they acted, failed to verify the allegations. As noted, the SEC, which had first heard the allegations in 1971, was again informed of the allegations on March 9, 1973, by the California Insurance Department,[7] but failed to take any action. On March 23, Blundell of *The Wall Street Journal*, who had by then been investigating independently for two days, informed Stanley Sporkin and Ralph Erickson of the SEC's Division of Enforcement in detail about the allegations. (J.A. 63, 132-33; Dirks Ex. R, J.A. 163-64, R. 7949, 7950) The SEC neither called Dirks (J.A. 63), nor took any other immediate action. As Sporkin later explained to a Congressional committee, even after hearing the detailed story the SEC considered the story to be an unverified rumor on which it could not act. (Boston Company III Ex. JJJ, p. 90, R. 8264, 8390)

On the evening of March 26, at Blundell's suggestion, Dirks called the head of the SEC's Los Angeles Regional Office at home and, accompanied by two former Equity Funding employees, went to the Regional Office the next day. Dirks testified for four days, telling the SEC everything he had heard about allegations of fraud at Equity Funding. (J.A. 61-62; Dirks Ex. R, J.A. 163, 164-65, R. 7949, 7950)

On March 27 the New York Stock Exchange, reacting to circulating rumors of fraud at Equity Funding, and a resultant

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[7] The California Insurance Department also notified the Illinois Insurance Department, which on March 13 sent two examiners to conduct its periodic examination of EFLIC. This examination, however, failed to verify the allegations until well after trading in Equity Funding's stock had been suspended.

complaint of "disorderliness" in the market (*see* Pet. App. A-10), halted trading in the company's securities. The SEC also suspended trading in the securities on March 28, even though at that point, after Dirks had been testifying for two days, the SEC official investigating the matter was not convinced the allegations were true.[8] (R. 8631, 8639) Likewise, an Exchange official investigating the matter, after reviewing the transcripts of Dirks' SEC testimony, concluded that the story "was not fact" supported by any hard evidence. (R. 9119-20; Bristol Ex. H, R. 8784, 8796) Indeed, the ALJ found that both the Exchange and the SEC acted "without awaiting proof of the allegations 'as a fact.' " (I.D. 132-35, J.A. 268-70)

The first hard evidence supporting the allegations did not come until March 30, when the Illinois Insurance Department discovered that substantial cash assets of Equity Funding, which were supposed to be in a Chicago bank, were missing, discovered other evidence of asset manipulation, and found that officers of Equity Funding had refused to sign affidavits swearing that there was no fraud. (I.D. 132-35, J.A. 268-70; R. 7059-69, 7070-73, 7206-07, 7418-19; Boston Co. III Exs. Z, R. 7215, 7219, 7673, YY, R. 7410, 7410, and ZZ, R. 7412, 7412; Bristol Ex. F, R. 6977, 6979) It was only at that point that the California Insurance Department stepped in and used its emergency powers to seize EFLIC. (R. 7209; Boston Co. III Exs. Z, R. 7215, 7219, 7673, and BBB, R. 7421, 7422) And it was only at that point that Blundell concluded that he could write a story reporting the allegations for the *Journal*. (J.A. 130)

Equity Funding filed a Chapter X petition on April 5, 1973. In 1975 the bankruptcy trustee issued a report detailing the results of his investigation into the company's activities. The

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[8] As Stanley Sporkin testified before Congress, trading was suspended because the SEC believed that either the allegations were true *or* there was a bear raid on the stock, but did not know which was the case. (Boston Company III Ex. JJJ, p. 90, R. 8264, 8390)

report confirmed some of Secrist's allegations, but also determined that many of them were false.

As a result of Dirks' efforts, a criminal fraud which had been ongoing since the mid-1960's, and which the regulators had failed to catch, in spite of being given repeated leads, was finally exposed. Following a seven-month investigation by the SEC, the FBI, the United States Attorney's Office in Los Angeles, and other agencies, a federal grand jury on November 1, 1973 returned a 105-count indictment against twenty-two participants in the fraud. All twenty-two were convicted and received sentences ranging up to eight years in prison, as well as substantial fines. (Division Ex. 80B, J.A. 149-53, R. 6594, 6595)

SUMMARY OF ARGUMENT

The court below held that petitioner Dirks aided and abetted violations of the antifraud provisions of the securities laws when he circulated allegations of an ongoing fraud at Equity Funding to persons in the investment community, some of whom later sold Equity Funding securities on the open market, even though it was agreed that Dirks was himself not an Equity Funding insider, was legitimately told of the allegations by former employees of the company, did not misappropriate the information, and even though both Dirks and his sources were under no fiduciary duty not to repeat these allegations to others. That holding is inconsistent with this Court's decision in *Chiarella* v. *United States*, 445 U.S. 222 (1980).

In *Chiarella*, this Court held that under the antifraud provisions of the securities laws a duty to disclose non-public information arises only out of a relationship between the person possessing the information and those purchasing or selling the securities. This Court held that such a duty does not arise as a result of the mere possession of such information. Even the dissenting Justices in *Chiarella* agreed that mere possession of such information may give rise to a duty of disclosure only where it is illegally obtained, *id.* at 239-43 (Burger, C.J.,

dissenting), or where it is not legally available to others in the investment community, *id.* at 245-52. (Blackmun, J., dissenting.)

Neither Dirks nor his company ever traded in Equity Funding securities. He was a stranger to, and had no relation of trust with, any purchaser of Equity Funding securities. The court below, and the Commission before it, nonetheless held that Dirks acquired a duty to "disclose-or-refrain" simply because he legally and properly obtained information about Equity Funding which the court held to be material and nonpublic.

The court first held that Dirks acquired such a duty because he was automatically a "tippee" of corporate insiders, and inherited whatever duties those insiders had to Equity Funding and its shareholders. This is incorrect. "Tippee" liability exists only where the recipient of the information improperly acquires it through a breach of a corporate insider's duty to the company, and thereby himself acquires duties as a participant in the breach. *See, e.g., Chiarella, supra,* 445 U.S. at 230 n.12; *In re Investors Management Co.*, 44 S.E.C. 633, 648-51 (1973) (concurring opinion). The SEC conceded, however, that Dirks' sources breached no duty in talking to him. Nor did Dirks misappropriate or illegally obtain the information from the company. He acquired the information from sources who were legally free to give it to him. (Pet. App. A-23) This information was, indeed, legally available to anyone willing to undertake the effort that Dirks did. Dirks' sources were willing and eager to discuss the allegations. Under such circumstances, Dirks did not acquire any duty.

Indeed, rather than violating a duty to Equity Funding or its shareholders, or to the market in general, Dirks' activities brought to light a massive fraud at Equity Funding and informed the market of the true state of affairs at the company. But for Dirks' efforts, the fraud might well have gone undetected altogether.

By misapplying controlling precedent, the court below reached a result that is entirely contrary to public law enforce-

ment policy and that will have a substantial negative impact throughout the securities industry. It is hard to imagine how, given his position as an outsider and the SEC's repeated failure to successfully investigate the fraud allegations, Dirks could have gone about publicizing them other than the way he did—by talking to the press and to anyone else who would listen to him. The SEC's suggestion of a duty to disclose and its "disclose or refrain" rhetoric may make sense where those in possession of the information, such as corporations or managers of corporations, are in a position to make disclosure on behalf of the company. But applying the "disclose or refrain" rhetoric to an outsider like Dirks who is investigating allegations of management fraud which will never be voluntarily disclosed by the management and who cannot persuade the press to publish a story will result only in discouraging independent investigation of such allegations. A more counterproductive result can hardly be imagined.

The court below also held that Dirks, because he was an employee of a registered broker-dealer, had a special duty of disclosure to the public and to the SEC. This holding was based solely on the theory that all securities professionals are supposed to maintain a high degree of ethics, and that such ethical duties can be translated into a fiduciary duty. This novel theory is entirely without foundation in the law, is inconsistent with *Chiarella*, and should not be allowed to stand.

Finally, the court erred in holding that the unverified allegations of fraud heard by Dirks were "material facts." Unsubstantiated and incredible rumors, which were vigorously denied by management and many of which proved ultimately to be wrong, are not "facts." *E.g.*, *SEC* v. *Monarch Fund*, 608 F.2d 938, 942 (2d Cir. 1979); *Hassig* v. *Pearson*, 565 F.2d 644 (10th Cir. 1977). The record shows that while some of those who heard the rumors sold their Equity Funding securities, many more either did nothing or actually purchased, or recommended purchasing, the stock. The SEC itself did nothing after hearing these allegations from a former Division of Enforcement attorney in November 1971. It continued to do

nothing after hearing them from the California Insurance Department on March 9, 1973, from a reporter for *The Wall Street Journal* on March 23, 1973, and from Dirks himself on March 27, 1973. When asked by a Congressional committee why the Commission and its staff had failed to act as late as March 27, Stanley Sporkin of the SEC responded that they had nothing but unverified rumors, upon which they could not responsibly act. No other court has ever held such uncertain and untrustworthy allegations to constitute "facts" under the antifraud provisions of the securities laws.

ARGUMENT

I. Dirks Was Under No Duty Within The Meaning of *Chiarella* v. *United States* With Respect to Allegations of Ongoing Criminal Fraud at Equity Funding

A. Dirks Did Not Acquire a Fiduciary Duty Where He Legitimately Acquired Information of Criminal Fraud from Equity Funding Employees, and Where the Employees Breached No Duty in Providing the Information to Him

In *Chiarella* v. *United States*, 445 U.S. 222 (1980), this Court held that "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak." *Id.* at 234-35. Furthermore, "the duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.' " *Id.* at 228, *quoting Restatement (Second) of Torts* § 551(2)(a) (1976).[9]

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[9] Because Rule 10b-5 is modeled after Section 17(a) to prohibit similar conduct, *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 212-13 n.32 (1976), these principles are equally applicable to the charges under that statute.

Contrary to the decisions below, Dirks had no such duty. Dirks acquired the information legitimately in the course of an investigation which led to the uncovering of a long-concealed fraud at Equity Funding. Dirks' sources did not breach any duty in providing the information to Dirks. Dirks was a stranger to, and did not himself have a fiduciary, or other relationship of trust and confidence with any purchaser of Equity Funding securities. Dirks was not an Equity Funding officer, director, or employee. He did not purchase or sell Equity Funding stock and was not involved as an agent or broker in any sale. There was, accordingly, no breach of any fiduciary or other duty by Dirks.

1. Dirks Was Not a "Tippee" Where He Acquired Information from Sources Who Breached No Duty in Giving Him the Information

The Commission and the Court of Appeals found that Dirks acquired a duty to disclose because, they held, he received material, nonpublic information from corporate insiders of Equity Funding, and thereby became a "tippee" of the insiders, subject to the same disclosure obligations that insiders have. (Pet. App. A-25; B-21) The finding that Dirks was a "tippee" of corporate insiders was incorrect.

As this Court recognized in *Chiarella*, while "tippees" may acquire fiduciary duties, this is not because they received inside information, but rather because they received the information *improperly:*

> "Tippees" of corporate insiders have been held liable under § 10(b) because they have a duty not to profit from the use of inside information that they know is confidential and know or should know came from a corporate insider. *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237-38 (CA2 1974). The tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty. Subcommittees of American Bar Association Section of Corporation, Banking, and Business Law, Comment Letter on Material, Non-Public Information (Oct. 13, 1973),

reprinted in BNA, Securities Regulation & Law Report No. 233, pp. D-1, D-2 (Jan. 2, 1974).

445 U.S. at 230 n.12.

"Tippee" liability has been imposed only in circumstances where the "tippee" has known, or has had reason to know, that he had improperly obtained inside corporate information. For example, in *In re Investors Management Co.*, 44 S.E.C. 633 (1971), the Commission stated that in finding "tippee" liability, "the appropriate test . . . is whether the recipient knew or had reason to know that the information was non-public and had been obtained *improperly* by selective revelation or otherwise." *Id.* at 643 (emphasis added). Commissioner Smith, concurring in *Investors Management*, expressly read this test to mean that before a "tippee" can be held liable it must be shown that he received information in breach of an insider's duty not to disclose it. *Id.* at 648-51.

The theory underlying "tippee" liability has been that confidential "inside" corporate information is an asset of the corporation and its shareholders. As such, it may only be used for legitimate corporate purposes and may not be appropriated by corporate insiders, who owe duties of trust and loyalty to the corporation, for their own use.

Disclosure of confidential corporate information for anything other than a legitimate business purpose, accordingly, constitutes a breach of trust. As Professor Brudney has observed, the insider is in effect selectively selling corporate information in a situation where he is forbidden to divulge it to the public. Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 Harv. L. Rev. 322, 348 (1979). Where an outsider who receives such information knows, or should know, that he has received confidential corporate information in breach of trust, it is a simple matter to hold him liable for any further use of the information.

As the ABA Comment Letter cited in footnote 12 of *Chiarella* stated:

> [It] appears that the Commission's view is based upon the premise that the tippee who does trade upon such information is a participant after the fact in the tipping corporate official's breach of fiduciary duty, and, under common law principles, the tippee may be held responsible for the consequences of that breach in appropriate cases.

ABA Comment Letter, *supra*, BNA Securities Regulation & Law Report (No. 233), at D-2 (citation omitted).

Indeed, this was the view of Professor Loss, who first coined the term "tippee": a "tippee" should only be liable under Rule 10b-5 where he "knew, or at least should reasonably have inferred, that an insider's tip was a 'breach of trust.'" 3 L. Loss, *Securities Regulation* 1451 (1961). Professor Loss traced "tippee" liability to the concept in the law of restitution that " '[w]here a fiduciary in violation of his duty to the beneficiary communicates confidential information to a third person, the third person, if he had notice of the violation of duty, holds upon a constructive trust for the beneficiary any profit which he makes through the use of such information.' " *Id.*, *quoting Restatement of Restitution* § 201(2) (1937).

Other authorities have likewise expressed the view that "tippee" liability exists only where there has been a breach of trust by an insider. *See Ross* v. *Licht*, 263 F. Supp. 395, 410 (S.D.N.Y. 1973); *Brudney*, *supra*, 93 Harv. L. Rev. at 348; Fleischer, Mundheim & Murphy, *An Initial Inquiry Into the Responsibility to Disclose Market Information*, 121 U. Pa. L. Rev. 798, 818 n.76 (1973); *cf.* 3 A. Bromberg & L. Lowenfels, *Securities Fraud & Commodities Fraud* § 7.5(3)(d), at 190.10 (transmission of information for legitimate corporate purpose is not "tipping"); 5A A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 92, at 4-28 (same).[10]

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[10] The Commission itself has never taken the position that "tippee" liability may be imposed where there has been no breach of fiduciary duty by the insider. All that it has said is that the recipient of the information need not have "actual knowledge that the information was disclosed in a breach of fiduciary duty not to reveal it." *In re*

The imposition of "tippee" liability under such circumstances is thus nothing more than an application of the well-accepted common law principle that one who acquires confidential corporate information through participation in misappropriation may become a "constructive trustee" of the corporation with fiduciary duties with respect to that information. *See* 5 A. Scott, *Scott on Trusts* § 506, at 3569-70 (1967).

In the present case, however, Dirks' sources did not breach any duty to Equity Funding by revealing to Dirks information about an ongoing criminal fraud at the company. Indeed, both the Commission and the court below conceded that Dirks' sources were under no obligation to keep evidence of a crime confidential. (*See* Pet. App. A-23; B-21 n.42; SEC Court of Appeals Brief at 50)

Dirks' sources were not disclosing corporate "inside" information. "Inside" information is "confidential information intended to be available only for a corporate purpose and not for the personal benefit of anyone." *Feldman* v. *Simkins Industries, Inc.*, 679 F.2d 1299, 1304 (9th Cir. 1982); *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961). The information was neither a legitimately confidential corporate asset nor intended for a corporate purpose. As one commentator on this case has observed, "[i]nformation relating to a gigantic corporate fraud upon others can scarcely be considered a corporate asset or as having a valid corporate purpose." Heller, *Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" versus Economic Theory*, 37 Bus. Law 517, 548 (1982).

In sum, Dirks was not a "tippee" as that term has previously been understood because he did not acquire inside information through an insider's breach of duty. As Professor Easterbrook, commenting on this case, has observed, "when the

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Faberge, Inc., 45 S.E.C. 249, 256 (1973); *see In re Investors Management Co.*, *supra*, 44 S.E.C. at 643. These statements indicate that a breach of duty by the insider is required, but that constructive knowledge of the breach will suffice.

release of information was not wrongful—and certainly the former employees of Equity Funding did no wrong in telling Dirks about the fraud—there is no justification for barring the use of the information." Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 S. Ct. Rev. 309, 338.

2. Dirks Did Not Misappropriate or Illegally Obtain Information About Equity Funding

In their opinions in *Chiarella*, Chief Justice Burger and Justice Brennan suggested that a fiduciary duty may arise with respect to nonpublic, material information where the information is obtained by unlawful means. 445 U.S. at 239-43 (Burger, C.J., dissenting); *id.* at 238-39 (Brennan, J., concurring). The Chief Justice stated, and Justice Brennan agreed, *see id.* at 239, that a disclosure obligation should exist "when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means," *id.* at 240.

In this case, Dirks obtained information about an ongoing criminal fraud at Equity Funding in a totally legitimate manner. He was given this information by sources who had a legal right to inform him of this massive crime. (Pet. App. A-23) Indeed, under the law of California, where Equity Funding was headquartered, these employees had a duty to expose fraud or face possible criminal liability. Cal. Corp. Code § 3019 (1955), now renumbered with technical emendations as Cal. Corp. Code § 2254 (1977). (Pet. App. A-23) And, as it turned out, Dirks was first approached by Secrist because Secrist wanted to expose the fraud, knew that prior approaches to regulatory agencies had gotten no results, and valued Dirks' reputation, in Judge Wright's words, as someone who had shown "willingness to go beyond mere financial data in evaluating investments." (Pet. App. A-4)(J.A 19) Any additional information Dirks obtained from his other sources was the result of "two weeks of concerted effort" (Pet. App. A-3), during which Dirks tracked down and spoke to sources identi-

fied by Secrist, evaluated their stories, and also sought out and evaluated information that might rebut or explain away those stories. This information was not only obtained in a totally legal manner, but was in fact obtained as a result of Dirks' "superior experience, foresight, or industry."

3. The Decisions Below that Dirks Acquired Fiduciary Duties Simply by Receiving Material, Nonpublic Information About Equity Funding Are Inconsistent with *Chiarella*

The court below recognized that there was no breach of duty by Dirks' sources and that Dirks himself had breached no preexisting duty to any purchaser of Equity Funding securities, but the court held that such a breach was not required—finding instead that *anyone* who acquires material, nonpublic information from an insider becomes, by virtue of having acquired such information, a fiduciary with respect to the information. (*See* Pet. App. A-24 to A-25, B-20 to B-21 & n.42) This holding is without foundation.[11]

Indeed, the decision of the Court of Appeals is directly contrary to this Court's decision in *Chiarella*. In *Chiarella*, this Court refused to find

> a general duty between all participants in market transactions to forego actions based on material, non-public information. Formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties . . . should not be undertaken absent some explicit evidence of congressional intent.

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[11] Both the court and Commission relied principally on *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974). In *Shapiro*, however, the tipper was an underwriter who had a fiduciary duty to its client company, as the SEC itself found in a related proceeding, and breached that duty in disclosing inside information of that client company to its "tippee" customers. *See In re Investors Management Co., supra*, 44 S.E.C. at 645.

Id. at 233.[12]

Yet the court below has formulated precisely such a broad duty, holding that solely because Dirks legitimately acquired material, nonpublic information about Equity Funding he automatically acquired a fiduciary duty. As one commentator has observed, this holding "amounts to a 'constructive breach' theory, one going well beyond the rationale offered in the *Chiarella* footnote [, and] is clearly a step removed from the 'common enterprise' approach, and a novel application of fiduciary attribution principles." Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 Cal. L. Rev. 1, 30 (1982) (footnote omitted).[13]

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[12] The Commission argued in the court below that *Chiarella* should be confined to cases involving "market" information and should not apply to cases involving information stemming from the corporation. Counsel for the Commission contended that the legislative history of the securities laws indicated that market information and "inside" information were intended to be treated differently, and that this was the basis for this Court's decision in *Chiarella*. (SEC Court of Appeals Brief at 55) In fact, this Court drew no such distinction in *Chiarella* and, as Chief Justice Burger noted, "[i]t is clear that § 10(b) and Rule 10b-5 by their terms and by their history make no such distinction." 445 U.S. at 241 n.1 (dissenting opinion), *citing* Brudney, *supra*, 93 Harv. L. Rev. at 329-33.

[13] Professor Langevoort went on to note that while the theory might be based on the concept that one who misappropriates confidential information is deemed a trustee *ex maleficio*, and may be held to account for his use of the information, for such a duty to be imposed "there must be some expectation of trust and confidence with respect to the information imparted, and the person receiving the information must assent at least implicitly to the expectation." *Id.* at 31 n.121. Here there was no expectation by Dirks' sources that he would keep their information in confidence, and there could not legitimately have been any such expectation. In fact, Secrist testified that his intention was to get the information out, drive the price of Equity Funding's stock down, and thereby force the various regulatory agencies to take action. (J.A. 15-16)

The decision below is also sharply at odds with what appears to be the only other post-*Chiarella* decision on this question to date. In *Walton* v. *Morgan Stanley & Co., Inc.*, 623 F.2d 796 (2d Cir. 1980), the Second Circuit Court of Appeals held that an investment banking firm did not acquire or breach any *Chiarella*-type fiduciary duty to a corporation which was not a client when it traded in the corporation's stock on the basis of confidential earnings reports it acquired from the corporation while investigating it for a client. *Id.* at 798-99. The investment banking firm had received the information legitimately, and while the firm knew that the information was confidential corporate data that came from inside the company, and had been expected to keep it so, the company had secured no agreement that the firm would do so. In the absence of any confidentiality agreement, or other fiduciary relationship, the court held, the investment bankers did not acquire any duty with respect to this information simply by receiving it legitimately. *Id.* at 799.[14]

To be sure, under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, or attorney working for the company, such outsiders may, as a result of such relationship, become fiduciaries of the company with an obligation not to use the information except for company purposes. The basis for such an obligation is not simply that such persons acquired nonpublic corporate information, but that they have a "confidential rela-

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[14] Although the SEC sought, in opposing the Petition for a Writ of Certiorari, to distinguish *Walton* on the ground that it was a state law case, the Second Circuit expressly noted that the type of duty at issue was precisely the type of duty required under *Chiarella*. For this reason, *Walton* has been viewed as being in direct conflict with this case. *See* Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, *supra*, 70 Cal. L. Rev. at 30-32.

tionship in the conduct of the business of the enterprise,"[15] and are given access to information "solely for corporate purposes." Brudney, *supra*, 93 Harv. L. Rev. at 347-48; *see SEC* v. *Monarch Fund*, 608 F.2d 938, 942 (2d Cir. 1979).[16] But as the court below and the Commission recognized, Dirks had no such confidential relationship with Equity Funding. He was not given this information in order to assist "in the conduct of the business" of Equity Funding but, rather, to expose a massive fraud at the company. As a result, the court below was reduced to finding a general duty applicable to anyone possessing what is found to be material, non-public information, even though this Court has made clear that no such duty exists.

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[15] Prior to *Chiarella* a few courts appeared to disclaim the need to find a "special relationship" between an outsider and the company, and at least implied that anyone who enjoys "unequal access" to nonpublic material information owes a duty to disclose or refrain from using that information. *See Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, *supra*, 495 F.2d at 236 & n.13; *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). In his dissenting opinion in *Chiarella* Justice Blackmun, joined by Justice Marshall, espoused this "unequal access" test. Although this Court rejected the "unequal access" test, even under Justice Blackmun's approach Dirks was under no duty to disclose-or-refrain. Justice Blackmun stated that he "would hold that persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage." 445 U.S. at 251. In this case the information was legally available to anyone who chose to seek out and talk to Dirks' sources. Dirks' sources were not only legally free to talk to anyone, but were eager and willing to talk. When given the opportunity they talked freely with Blundell of *The Wall Street Journal* (J.A. 17, 61-62), and with other investors (J.A. 39-40). Dirks was not exploiting a "structural informational advantage." If he obtained any informational advantage, it was because of the exercise by him of superior skill and diligence.

[16] The Commission itself has taken a similar approach in finding persons who have legitimately received non-public information liable for trading on that information. For example, in *In re Cady, Roberts & Co.*, *supra*, the Commission said "our task here is to identify those

4. The Decisions Below Elevate Information of Criminal Fraud to the Level of Legitimate "Inside" Information and Will Deter the Detection of Such Fraud

The decisions below not only have no support and are inconsistent with *Chiarella*, but are also contrary to public policy. They have the effect of elevating information about an ongoing criminal fraud to the level of legitimate "inside" information, and granting such information the status of secret "inside" information. As noted, what Dirks' sources disclosed was not "inside" information intended for a confidential corporate purpose, but was evidence of a crime.

The decisions below work to shield perpetrators of corporate crimes by holding information about such crimes to be a confidential corporate asset, and by holding those who acquire such information to be fiduciaries of the corporation with respect to such information. This result is contrary to the public interest. Legitimate "inside" information is properly kept confidential for the benefit of the corporation. To the extent the market has an interest in such information, it will either eventually be revealed or reflected in the corporation's financial statements. But, as Professor Kenneth Scott has observed, there is a critical distinction between the use of "inside" information and the situation presented here. Since inside information eventually will be disclosed by the company,

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persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities." 40 S.E.C. at 912. In *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933 (1968), the Commission pointed out that Merrill Lynch had only acquired inside information "by virtue of its business relationship with the issuer." *Id.* at 937. In a subsequent related proceeding, the Commission construed this relationship to be a "corporate insider position that Merrill Lynch in effect occupied by virtue of its role in assisting Douglas in its corporate financing functions." *In re Investors Management Co.*, *supra*, 44 S.E.C. at 645. *See also In re Van Alstyne, Noel & Co.*, 43 S.E.C. 1080, 1085 (1969) (underwriter found liable under Rule 10b-5 on theory that it enjoyed "access by virtue of a special relationship to the issuer to material information").

or accurately reflected in its financial statements, the use of inside information does nothing more than allow the possessors to get a jump on the market, thereby "accomplishing nothing but some wealth transfers. Equity Funding, however, represents an outsider expending efforts to discover fraud, and fraud detection is a socially valuable activity." Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. Leg. Stud. 801, 813 (1980).

Unlike "inside" information, information of corporate crime by senior management will almost never be disclosed voluntarily. The Equity Funding fraud had gone on for years undetected. As a number of observers have noted, it was only Dirks' possession and use of the allegations that informed the market that something might be wrong at Equity Funding and that brought the fraud to light. *See* H. Kripke, *The SEC And Corporate Disclosure: Regulation in Search of a Purpose* 295 (1979); Heller, *Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" versus Economic Theory*, *supra*, at 549-50; Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, *supra*, at 337. Indeed, Stanley Goldblum, the former president of Equity Funding who was sentenced to eight years in prison for his part in the fraud, was of the view that but for Dirks the Equity Funding fraud could have been successfully buried, perhaps forever (J.A. 116-17), and that Dirks is "entitled to personal credit" for uncovering the fraud. (J.A. 115)

By equating information of criminal fraud with "inside" information, the decisions below assure that such information will be treated secretly by outsiders who become aware of it, and that the fraud will remain hidden. As Professor Kenneth Scott has commented, *supra*, at 818, "the SEC's Equity Funding position is a boon to the successful commission and prolongation of corporate fraud." The securities laws do not command a result so contrary to public policy, and so sure to deter others who, like Dirks, would seek to ferret out and expose corporate fraud.

In particular, the decisions below will greatly inhibit the independent securities analyst, who often is in a position to learn of and investigate allegations of corporate wrongdoing, from conducting such investigations. Rumors and allegations of wrongdoing, often circulated by disgruntled former employees like Secrist, are frequently heard by those in the investment community. (*See* J.A. 78-81, 119, 126; R. 8888, 8928-29) Under the decisions below, an analyst like Dirks who hears of allegations of fraud has two choices. He can make the allegations public, which as the present case demonstrates, is practically impossible for an analyst who has no control over the regulatory process or the media.

Alternatively, he can remain silent. Indeed, in its oral argument to the Commission the SEC staff explicitly argued that it would have been appropriate for Dirks to have done "nothing" with the allegations.

Either way, the public is deprived of the benefits of independent investigations because the analyst has no incentive to investigate. The court below failed to understand this. It recognized that Dirks' activities served the public interest because he uncovered and exposed "one of the most infamous frauds in recent memory" (Pet. App. A-3), and "[b]oth the State and the public at large have an interest in exposing corporate misconduct." (Pet. App. A-25) But it suggested that Dirks should nonetheless be condemned because rather than investigating and exposing the fraud as a free public service, "he was compensated for so doing." (Pet. App. C-2; *id.* A-9, A-38 to A-40)

The comment that Dirks was compensated is substantially wrong as a matter of fact.[17] But more important, it ignores the obvious point that public policy encourages uncovering serious

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[17] This comment is a reference to the fact that of the literally dozens of persons and companies to whom Dirks reported the allegations—some of whom bought, some of whom sold, and some of whom did neither—one decided to give the company which employed Dirks some additional commission business. (Pet. App. A-9 n.5)

corporate fraud even if the investigation is not motivated entirely by altruism. As Judge Wright correctly conceded, a reason why an independent financial analyst would undertake an investigation while the regulatory agencies and the press failed to act, was that the analyst (here Dirks) has "more immediate financial and reputational incentives to discover the truth. . . ." (Pet. App. A-26) In undertaking his investigation, Dirks was engaging in the normal business activities of securities analysts. (Pet. App. A-39) If an investigation had not held out the possibility of financial or at least reputational benefit (which, indirectly, might translate into financial benefit), no analyst would be likely to investigate.

The decision below removes such "financial and reputational incentives" by imposing on analysts an obligation, if their research uncovers any evidence of fraud or misconduct, to disclose it publicly (which, as noted, is probably impossible) or face the prospect of a securities fraud charge themselves. This virtually guarantees that neither Dirks nor any other securities professional will invest his time and energy in investigating allegations of corporate fraud. Such a result is contrary to the common understanding of the role of the securities analyst and contrary to common sense. It is based on the explicit assumption that it is illegal to hope for financial reward for diligent service to the community, such as the exposure of crime, an assumption without support in the securities laws and contrary to longstanding public policy which supports rewards for those who expose crime. As Professor Lorie of the University of Chicago Business School has said, "[w]e should see to it that the Raymond Dirkses of the future get gold medals rather than censure and other punishment." Lorie, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy: A Comment*, 9 J. Leg. Stud. 819, 822 (1980).

B. Dirks Did Not Acquire a Fiduciary Duty by Virtue of His Position as an Employee of a Broker-Dealer

The court below also found that Dirks aided and abetted violations of Rule 10b-5 and Section 17(a) because, as an em-

ployee of a registered broker-dealer, he "breached his duty to the Commission and to the public not to misuse insider information." (Pet. App. C-1) Indeed, this was the sole express ground stated by the court in its two-judge judgment and was deemed by Judge Wright to be the "more important" ground for decision. (Pet. App. A-27)[18] This novel holding of the Court of Appeals expands the scope of Section 10(b) far beyond the limits set by this Court's decision in *Chiarella*. This is the only decision that has ever found that a broker-dealer has a general duty to the public and to the SEC that satisfies the requirements of *Chiarella*.[19]

There is no such duty. Although the court below purported to be affirming a conclusion of the Commission, the Commission never found that petitioner owed or breached any duty to the public or to the Commission. Such a position was never urged upon the Commission by the Division of Enforcement and the Commission itself did not take such a position in its decision or before the Court of Appeals. Moreover, the imposition by the Court of Appeals of such a duty is an unwarranted expansion of Section 10(b) and is inconsistent with *Chiarella*.

The basis, in Judge Wright's opinion, for imposing such a duty, is that broker-dealers are obligated to meet a high ethical standard which "restrains broker-dealers not only in their dealings with their customers, but also in their dealings with the SEC and the public at large." (Pet. App. A-29) Thus, regardless of how Dirks obtained his information, in Judge Wright's view he "violated his duties to the SEC and the public by failing to report promptly what he knew." (Pet. App. A-31)

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[18] This ground for decision was wholly separate from the finding that Dirks acquired fiduciary duties from insiders. (*See* Pet. App. A-27)

[19] The cases since *Chiarella* which have found a breach of duty have limited that duty to a specific group of identifiable persons. *See, e.g., United States* v. *Newman*, 664 F.2d 12, 16-19 (2d Cir. 1981); *SEC* v. *Murphy*, 626 F.2d 633, 652 n.23 (9th Cir. 1980); *SEC* v. *Lund*, [1981-82] Fed. Sec. L. Rep. (CCH) ¶ 98,428 (C.D. Cal. 1982).

Judge Wright noted that the Securities Exchange Act of 1934 imposes on broker-dealers "myriad duties not imposed on corporate officers or other members of the general public." (Pet. App. A-27) But he nowhere found in that scheme of regulation any express duty of disclosure owed by broker-dealers to the public or the SEC. In fact, even Judge Wright conceded that "the main focus of the SEC's regulation of broker-dealers has been to ensure that broker-dealers treat their customers honestly and fairly." (Pet. App. A-28)[20]

Judge Wright instead conjured up this duty out of the statement by this Court, in *United States* v. *Naftalin*, 441 U.S. 768 (1979), that an objective of the securities laws is to achieve a high standard of ethics "in every facet of the securities industry," *id.* at 775. (Pet. App. A-28) Judge Wright also noted that the legislative history of the securities laws indicates that they were designed to prevent the sale to the public of unsound or worthless securities. Judge Wright found that "Dirks' conduct was fundamentally inconsistent with 'prevent[ing] further exploitation of the public by the sale of unsound, fraudulent, and worthless securities.'" (Pet. App. A-30) From these general

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[20] Judge Wright also cited two court cases, an SEC decision, and a law review article for the proposition that special duties are imposed on broker-dealers. This authority stands for nothing more than the proposition that broker-dealers owe a special implied duty of fair dealing to their *customers*. *See Charles Hughes & Co.* v. *S.E.C.*, 139 F.2d 434 (2d Cir.), *cert. denied*, 321 U.S. 786 (1943); *In re Duker & Duker*, 6 S.E.C. 386 (1939); Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 Corn. L. Rev. 869, 876-81 (1972). The other case cited by Judge Wright, *O'Neill* v. *Maytag*, 339 F.2d 764 (2d Cir. 1964), stands for the proposition that a nondeceptive breach of fiduciary duty "created with particular reference to the purchase or sale of securities" might be actionable under Rule 10b-5, even though other nondeceptive breaches might not be. Although the court indicated in *dictum* that broker-dealers and investment advisers might have such duties, it never suggested that they have such duties toward anyone other than their customers.

statements of legislative intent, and nothing more, Judge Wright has created a duty owed by broker-dealers and their employees to all members of the public and the SEC.

This decision has enormous potential ramifications for broker-dealers, as well as for the rest of those professionals who deal "in every facet of the securities industry" and who should be held to high ethical standards. By Judge Wright's logic, the fiduciary duty imposed on Dirks can be imposed on any persons who are engaged in any facet of the securities industry, and who owe the investing public an obligation to behave ethically. The same duty could be found to apply to lawyers and accountants who deal with the issuance of securities, to financial columnists who are involved intimately with the workings of the market, and, for that matter, could have been found to apply to financial printers like Chiarella.

The decision below is completely inconsistent with *Chiarella*. In *Chiarella* this Court required that there be a specific relationship giving rise to a fiduciary duty to disclose before liability can be imposed for nondisclosure under the antifraud provisions of the securities laws. Instead of finding such a specific duty on Dirks' part, the court below has equated ethical *dicta* with fiduciary duties, and has converted an alleged breach of ethics into fraud. If, as the court below held, a fiduciary duty required under *Chiarella* means nothing more than the duty to behave in an ethical fashion, with the decision as to what is ethical to be made in each case by the judge, without reference to a predetermined legally prescribed standard, the requirement of a fiduciary duty will be meaningless, and perhaps even unconstitutionally vague, *see United States* v. *L. Cohen Grocery Co.*, 255 U.S. 81, 89-93 (1921). In the guise of finding a duty under *Chiarella*, the decision below effectively eviscerates that decision, and should be reversed.

II. The Unverified Rumors That Dirks Learned of Did Not Constitute Material "Facts"

A. The Antifraud Provisions of the Securities Laws Apply Only to "Facts"

The courts have uniformly held that Section 10(b), Rule 10b-5, and Section 17(a) apply only to misstatements or omissions of "material fact," *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976), and not to rumors, allegations, and other unverified information. *See SEC* v. *Monarch Fund, supra*, 608 F.2d at 942; *Hassig* v. *Pearson*, 565 F.2d 644 (10th Cir. 1977); *Marx & Co.* v. *The Diner's Club, Inc.*, 550 F.2d 505 (2d Cir.), *cert. denied*, 434 U.S. 861 (1977); *Alaska Interstate Co.* v. *McMillian*, 402 F. Supp. 532, 567 (D. Del. 1975); *Ruszkowski* v. *Hugh Johnson & Co., Inc.*, 302 F. Supp. 1371, 1376 (W.D.N.Y. 1969).

The Court of Appeals nonetheless affirmed the Commission's finding that the information disseminated by Dirks consisted of "material facts." What Dirks disclosed were not "facts"—they were unverified rumors and allegations—and the Commission and the court improperly held that they were "facts" for purposes of the securities laws.[21]

B. The Allegations and Rumors Reported to Dirks Were Not "Facts"

1. Unconfirmed Claims of Fraud Denied by Management Are Not Facts

The Commission stated in its opinion that even though neither Secrist nor Dirks' other sources offered hard evidence, the

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[21] Indeed, in two reported cases dealing with some of the same Equity Funding allegations heard by Dirks, two courts have held that the allegations were rumors, not facts, and that there was no obligation to disclose them. *See Pachter* v. *Merrill Lynch, Pierce, Fenner & Smith*, 444 F. Supp. 414, 422 (E.D.N.Y.), *aff'd mem.*, 594 F.2d 852 (2d Cir. 1978); *Wiener* v. *Oppenheimer & Co.*, [1979] Fed. Sec. L. Rep. (CCH) ¶ 96,764, at 95,001 (S.D.N.Y. 1979).

allegations nonetheless had "objective indicia of reliability" because they came from a former vice president of EFLIC; were specific and detailed; and because Secrist identified others who he said could corroborate his story. (Pet. App. B-14 to B-15) Judge Wright likewise stated that at least by the end of Dirks' investigation he had heard allegations in "enough specificity to satisfy Rule 10b-5." (Pet. App. A-34) These factors provided no such "indicia of . . . reliability."

First, that Secrist was a former employee of EFLIC was in fact cause for suspicion of his motives. Dirks found out that Secrist had been fired by the company and was lying when he had claimed to have resigned in protest over company policies. Indeed, virtually every witness who learned that Secrist was the source of the rumors testified that he tended to discount them as the allegations of a disgruntled ex-employee. (J.A. 126-27; R. 2137, 7180, 7193-94, 8743-45, 10,030)

Second, that Secrist's story was detailed did not make it reliable. Quite the contrary. Dirks quickly checked out many details of Secrist's story and found that they were wrong.[22] Moreover, Secrist himself discounted his information, saying that only 1% was based on his own experience, and that many of his conclusions were pure deduction. (R. 710-11, 718, 743) Given the fantastic nature of Secrist's story, Dirks' repeated discoveries that significant aspects of the story were erroneous obviously tended to discredit the allegations.

Finally, that Secrist identified others whom he thought might corroborate his story did not add much to his credibility because the others were themselves generally only aware of the same rumors Secrist was aware of, had no hard evidence,

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[22] These included a statement that EFLIC's salesmen-to-sales ratio would prove the existence of fictitious insurance (R. 1881-83), an assertion that EFLIC's business had doubled between December 15 and December 31 (R. 5424-27), and an allegation that Haskins & Sells had dropped the EFLIC account. (R. 1448-49, 5413, 5415)

and indeed had no knowledge of Equity Funding's current practices.[23]

More important, however, is that these claims of "indicia of reliability" totally ignore the critical facts.

First, of the eight allegations regarding Equity Funding made by Secrist, only three—relating to the creation by Equity Funding of fictitious insurance policies and certificates of deposit—turned out to be true. Each of the remaining major allegations, which included allegations that Equity Funding only had $10,000,000 in assets, that it had fictitious real estate on its books and was selling it through limited partnerships, and that Haskins & Sells had refused to continue as auditor for EFLIC, was as believable, if not more so, and had the same "indicia of reliability" as the first three. And yet, each of these allegations ultimately turned out to be false.[24]

Second, each of the allegations was denied in detail by the management of the company—including persons who were in a position to know and were not alleged by Secrist to be implicated in the alleged fraud. (Secrist was wrong here, too, because Goldblum, the Chairman and President of Equity Funding, was involved although Secrist had said he was not.)

What Dirks knew by the end of his investigation were not facts. All that he knew was that a fired employee of Equity Funding told him a detailed, inherently unbelievable (and, it turned out, partly true and partly false) story of fraudulent activities at the company, but had no firm evidence of any such widespread fraud. He also knew that several other former

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[23] Moreover, Secrist's characterization of these other persons as people who were "wild, and erratic, and given to elaborate fantasies" (R. 710-11, 718, 743, 757) did not exactly suggest that everything they said should be taken at face value.

[24] Judge Wright sought to overcome this problem by asserting that the ALJ found that by March 23 Dirks had separated out the true from the false, and was only relating those allegations he knew to be "substantially true." (Pet. App. A-34 n.25) In fact, the ALJ made no such finding. (I.D. 97-103, J.A. 242-46)

employees had heard of such a fraud, and believed they might have been involved in suspicious activities a few years earlier, but also had no evidence of continuing fraud. Dirks also knew that top management of Equity Funding denied the allegations completely and had seen evidence presented by management that tended to discredit the allegations. Dirks had spoken with Equity Funding's present and past auditors, both of whom told him they could not see how such a massive fraud could be carried out.

While Dirks plainly did not believe that the story was definitely untrue, and certainly did believe that it merited further investigation, he obtained no proof of fraud at Equity Funding. Indeed, Dirks' purpose in talking to others, including the *Journal*, Equity Funding's auditors, and members of the investment community, was to bring those persons' resources to bear in the investigation, to either confirm or refute the allegations. (J.A. 49-50, 56-57, 58, 71-72) At most Dirks' professional instincts, honed over years in the securities business, told him that this was a story which might well prove true upon further investigation. While Dirks' suspicions were ultimately proven correct, however, this was not until well after trading in Equity Funding securities was suspended. During his investigation, all that Dirks had to offer were unverified allegations and his best professional hunch.

2. The Allegations Were Not Treated as "Facts" by Those Who Heard Them

That these allegations were nothing more than unverified, and inherently improbable, stories, is confirmed by the reactions of sophisticated analysts, investors and officials who heard the allegations regarding Equity Funding from Dirks or otherwise.

(a) The allegations were by and large rejected by the investment community. Although some investors who heard the allegations sold their Equity Funding stock, many others

either did nothing or actually purchased additional Equity Funding stock. For example:

—Dirks' investigation was described in detail to Gene Mercy of Goldman, Sachs, who had previously heard the allegations and had bought a large block of Equity Funding stock in response. (R. 4562-63, 4566, 4578-83, 4629, 4642-44; 6447, 6486, 6490, 6514, 6521-24; Division Ex. 43, R. 3379, 3422) Mercy personally owned $55,000 in Equity Funding convertible debentures which he never tried to sell. (R. 6436, 6482) Goldman, Sachs continued to trade in Equity Funding stock throughout March 1973. (Division Exs. 42, R. 3378, 3406, and 43, R. 3379, 3422)

—On March 26 and 27, Dirks related the allegations to Harold Richards of Fidelity Corporation of Virginia, which Richards described as Equity Funding's largest shareholder. Fidelity did not sell any of its Equity Funding stock. (J.A. 65; R. 1393-96, 1794-96)

—Dirks described the allegations to Jerome Fine of Steinhardt, Fine and Berkowitz, which afterward purchased 88,000 shares of Equity Funding stock. (R. 1402-04, 1801)

—On March 23, Goldblum discussed the allegations with Laurence Tisch, President of Loews Corporation, a major investor in Equity Funding. Thereafter, Tisch had Loews buy 30,000 additional shares of Equity Funding on March 23 and place an order for 500,000 more shares on March 26. (R. 8486-88, 8563-64; Division Ex. 42, R. 3378, 3406 and 43, R. 3379, 3422)

The evidence shows that many other members of the investment community heard some or all of the allegations of fraud and wrongdoing at Equity Funding prior to the halting of trading on March 27.[25] There is no evidence that any of these people thought the allegations substantial enough to report to any regulatory agency or, where these people bought or sold

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[25] This evidence is discussed in detail at pages 20-21, 24-25, 28-29, and 32-35 of Petitioner's Brief in the Court of Appeals.

Equity Funding stock in March 1973, to the other party to the transaction.

(b) The allegations were not considered to be "facts" by the regulatory agencies with jurisdiction over Equity Funding. The improbable nature of these allegations is demonstrated not only by the fact that virtually no one in the investment community, upon hearing the allegations, sought to bring them to the attention of the regulatory bodies with jurisdiction over Equity Funding, but also by the fact that when these regulatory bodies were informed of the allegations, they did not consider them substantial enough to act on or, if they investigated the matter, could not corroborate them.

Secrist himself advised the New York Insurance Department of his suspicions during a two-hour meeting on the same day he met with Dirks for the first time. Other than passing on the allegation to the California Insurance Department and eventually advising the SEC and New Jersey Insurance Department, the department took no action.

The California Insurance Department relayed these allegations to the SEC on March 9. (J.A. 91-98; R. 7746, 7749-50; Boston Co. III Exs. DDD, R. 7619, 7619, and EEE, R. 7635, 7635) The SEC regional office attorney told the Department that the source of the reports was a disgruntled ex-employee, that they had been investigated in the past, and that it would be at least two to three months before any active work could be done.[26] (J.A. 92-98; R. 7674-76, 7712, 7716; Boston Co. III Ex. HHH, J.A. 171-72, R. 7702, 7717)

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[26] The California Insurance Department, while not believing the allegations (R. 7190-91, 7194; 7468-69), reported them to the Illinois Insurance Department, which had jurisdiction over EFLIC, an Illinois corporation. (R. 7176-77, 7230; 7282-84, 7292) The Illinois department, while finding the allegations incredible, sent two examiners to California to conduct EFLIC's periodic examination. (R. 6976, 6989-95, 7002-04, 7011-12, 7140-42; Bristol Ex. F, p. 1, R. 6977, 6979) These two examiners arrived on March 13, and by the time they were joined by a California examiner on March 21, had found no evidence of fictitious insurance. (R. 7018; Bristol Ex. F, p. 2, R. 6977, 6979)

Goldblum, the President of Equity Funding, met with two staffers of the New York Stock Exchange on March 23, at their request, to explain the rumors. After hearing his explanation, no further action was taken. (R. 8502-05)

Blundell of *The Wall Street Journal* spoke on March 23 with Stanley Sporkin in Washington and Ralph Erickson in Los Angeles of the SEC's Division of Enforcement and told them the allegations in detail. (J.A. 63, 132-33; Dirks Ex. R, J.A. 163-64, R. 7949, 7950) The SEC did nothing for several days. (R. 8350, 8454-56; 8703-05)

Stanley Sporkin, who was then Deputy Director of the SEC Division of Enforcement, later explained to Congress why he waited nearly a week after Blundell's detailed account to press for the suspension of trading in Equity Funding securities:

> I just wanted to emphasize that I think the Chairman had mentioned, that we cannot suspend trading merely on the basis of some rumor. We must have more information than that. In this case, in fact, a lot more had been done at that time. The [NYSE] had called Equity Funding in and Mr. Goldblum of the company had denied these rumors. We were really in a quandry on the week of March 26 about what we should do. We had no real verification of the facts.

Hearings Before Subcomms. of the Senate Comm. on Appropriations, 93d Cong., 1st Sess. 90 (1973) (Boston Co. III Ex. JJJ, p. 90, R. 8264, 8390)

Even when, on March 27, the New York Stock Exchange suspended trading in the company's stock, it did so as a result of disorder in the market being caused by the rumors, but did not have any proof that the rumors were true (R. 8841-43, 8923-24, 8927; Bristol Exs. G, R. 8784, 8796, and K, R. 8784, 8796), and later learned that the SEC and state insurance departments had no such proof either. (R. 7374-76; 8846-49, 8855-56, 8862-65, 8869-70, 8908-11; Bristol Ex. K, R. 8784, 8796) The Exchange, after reviewing transcripts of Dirks' testimony before the SEC, still believed that the claims were "not fact." (R. 9119-20; Bristol Ex. H, R. 8784, 8796) Indeed, when the SEC suspended trading in the stock on March 28, the

SEC official investigating the matter, after talking with Dirks for two days, was not convinced that the rumors were true. (I.D. 133-35, J.A. 269-70; R. 8631, 8639) And when trading was suspended in Equity Funding stock, the *Journal* still did not believe that it had sufficient evidence on which it could publish a story. (R. 1366-67, 1940; R. 8700-02, 8748)

In fact, the ALJ conceded that it was not until March 30 that facts were developed by anyone which made the allegations even "highly probable." (I.D. 133, 135, J.A. 268-69, 270)

* * *

The difference between this case and a true "fact" case like *In re Cady, Roberts & Co., supra*, or *SEC* v. *Texas Gulf Sulphur Co., supra*, is obvious. When one of Curtiss-Wright's directors in *Cady, Roberts* tipped people about the company's cut in dividend, no one bought the stock. They knew what he said was reliable and what it meant. When Texas Gulf insiders tipped people about mineral finds, no one sold the stock. Again, they knew the information was reliable and what it meant. In contrast, the reaction in the investment community, as well as regulatory agencies, in the present case makes it clear that the Secrist allegations, which were denied by Equity Funding management, were simply not "facts."

The effect of holding that uncorroborated allegations of fraud are "facts" which must be disclosed, will substantially deter the independent investigation of fraud allegations by independent analysts who, as noted, are often in a position to make such investigation. Any time an analyst uncovers or develops negative allegations or rumors on a company, he will be required to make public disclosure of the allegations (even though that is practically impossible with respect to unverified stories) or remain silent. If he seeks to explore the allegations, the dissemination of the story may cause some of those who hear it to credit the allegations and sell their stock. If it turns out that the allegations are well founded, or even if they are not but their effect is that the stock is worth less than the price at which it was sold, it can be expected that the purchasers will

turn around and sue the analyst under Rule 10b-5. Rather than risk this, the safe course for the analyst will be to ignore the allegations. That will simply assure that the true facts will remain hidden. This result is not required under the antifraud provisions of the securities laws, and is contrary to sound public policy.

CONCLUSION

For the foregoing reasons, the decision below of the Court of Appeals should be reversed.

Respectfully submitted,

DAVID BONDERMAN
Counsel of Record

LAWRENCE A. SCHNEIDER
ERIC SUMMERGRAD

ARNOLD & PORTER
1200 New Hampshire Ave., N.W.
Washington, D.C. 20036
(202) 872-6700
Attorneys for Petitioner
Raymond L. Dirks

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In the Supreme Court of the United States

October Term, 1960

RAYMOND L. DOTY, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

DANIEL M. GOLDBERG,
General Counsel

PAUL GONSON,
Solicitor

MORTON H. SOBONPAUER,
Associate General Counsel

WILLIAM ADAMS,
Assistant General Counsel

LEONARD B. L. WEIL,
Senior Special Counsel

DAVID E. FEINBERG,
WILLIAM S. TRIER,
Attorneys

Securities and Exchange Commission
Washington, D. C. 20549

QUESTIONS PRESENTED

1. Whether the traditional prohibition against defrauding investors by trading on inside information, recognized by this Court in *Chiarella* v. *United States*, 445 U.S. 222 (1980), is ousted when the inside information relates to criminal conduct.

2. Whether substantial evidence in the record supports the finding of the Securities and Exchange Commission, affirmed by the court of appeals, that nonpublic information that a company had vastly overstated its reported assets and earnings was "material" under antifraud provisions of the federal securities laws.

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In the Supreme Court of the United States

OCTOBER TERM, 1982

No. 82-276

RAYMOND L. DIRKS, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

STATEMENT

1. *Proceedings Below*

Petitioner Raymond L. Dirks caused institutional investors to sell $17 million of securities to uninformed and unsuspecting purchasers by giving these institutional investors inside corporate information that the securities were in fact virtually worthless. Between March 12, 1973, and March 27, 1973, Dirks, a securities analyst, privately informed five institutional investors that Equity Funding Corporation of America ("Equity Funding") had, as a result of fraudulent business practices, vastly overstated its reported assets and earnings. This information had been given to Dirks by former and current Equity Funding employees. Consistent with Dirks' expectation in providing them this nonpublic information, the institu-

tions sold over $17 million of worthless Equity Funding securities, mostly in transactions on the New York Stock Exchange ("NYSE"). Dirks did not report this information about fraud to any law enforcement authorities for three weeks while his tippees traded on the information.

The Commission brought an administrative proceeding against Dirks and the five institutions to determine whether their conduct violated Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Commission Rule 10b-5, 17 C.F.R. 240.10b-5 (J.A. 1-13). The administrative law judge, and the Commission on review (21 SEC Docket 1401), determined that the conduct violated these antifraud provisions. Dirks was censured and four of the institutional investors were also sanctioned. The court of appeals affirmed. 681 F.2d 824.

2. *The Facts*

In March 1973, Dirks was vice-president of a NYSE member broker-dealer firm. Dirks provided investment analysis on insurance company securities to institutional investors that in turn directed brokerage commission business to his firm (J.A. 178; R. 473-76, 1883-87). Dirks also published a "weekly scandal sheet" reporting his analyses to 500 institutional investors from which he hoped to derive brokerage business (J.A. 178; *id.* at 146-48; R. 473-76, 1883-87).

Equity Funding was a California holding company with life insurance subsidiaries chartered in Illinois, New York and other states. Equity Funding's common stock and certain of its debentures were traded on the NYSE. In the 1960's, Equity Funding began to record fictitious life insurance business on its books to inflate the market values of its securities. In about 1970, Equity Funding started selling, through reinsurance arrangements with other life insurance companies, fictitious policies as though they were real (R. 10,772-83).

The practice of selling fictitious policies was like a "Ponzi" scheme,[1] in that Equity Funding was required to reinsure ever greater numbers of policies in order to pay the premiums due on the previously reinsured policies and thereby forestall discovery of its scheme (*id*).[2] Like any Ponzi scheme, the reinsurance scheme eventually had to collapse from its own weight (R. 10,772, 10,780).[3] By early 1973, when Dirks' activities took place, the collapse was apparently near. Almost two-thirds of the insurance reportedly issued by the company was fictitious, and the company was already in such financial distress that management decided to fire 20 percent of its employees (R. 535, 11,033; see also Pet. App. B11 n.19).

Ronald Secrist, a former Equity Funding vice president discharged in Equity Funding's company-wide reduction-in-force, wanted to put an end to these practices (R. 182-83, 509). Based upon gossip at the company, Secrist believed that other employees had previously reported the company's practices to regulatory authorities, including the Commission, but had been "brushed aside with a comment that that's a ridiculous story * * *" (J.A. 16, 22, 25, 66). Secrist decided to report the company's practices to only one regulatory authority—the New York State Insurance Department. Apparently believing that he too might be brushed aside by the regulators, Secrist also decided to reveal the information to

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[1] See *Cunningham* v. *Brown*, 265 U.S. 1 (1924). Dirks himself stated that the fraud was a "short-run [P]onzi-type scheme" (R. 534; see also J.A. 197).

[2] According to the practice in the industry, Equity Funding was required to transmit to its reinsurers 90% of all premium payments made by policy holders on policies that were reinsured. Since there were no policy holders to make premium payments on the fictitious policies, Equity Funding was compelled to generate cash to make payments to its reinsurers or face exposure of its fraud (R. 10,772, 10,780-81; see also Pet. App. B4 n.6).

[3] Equity Funding's bankruptcy reorganization trustee concluded: "Ultimately, the house of cards had to fall" (R. 10,780-81); see also J.A. 124.

Dirks, who Secrist believed would understand his story (J.A. 16, 19). Secrist intended that Dirks would disseminate the information "to his firm's customers," whose trading on the information would "jar" the price of the stock and "finally force [the regulators] to move" (J.A. 16, 25, 26).[4] As it turned out, Secrist was wrong in both his beliefs: no Equity Funding employee had ever reported the company's practices to the Commission, and Secrist's report was not "brushed aside" by the regulators.

A. Secrist Informs the Insurance Regulators, and They Commence an Examination of Equity Funding

During the morning of Wednesday, March 7, 1973, Secrist told the New York insurance regulators that at least one-third of the insurance reportedly issued by Equity Funding's Illinois subsidiary, Equity Funding Life Insurance Company ("EFLIC"), was fictitious, that Equity Funding was reinsuring this fictitious insurance, and that Equity Funding was engaged in other fraudulent practices (J.A. 23, 192-94; R. 219-59, 479-567). He described in detail how top-echelon management, with the cooperation of corrupt auditors, had operated and concealed the fraudulent scheme (*id.*). The New York staff who heard Secrist's story was "convinced" that Secrist was telling "the truth" (J.A. 83-84).

The New York staff concluded that prompt action was in order. They assured themselves that policyholders of Equity Funding's New York subsidiary were not in any immediate danger[5] and referred Secrist's disclosures to the state insurance regulators in California, where Equity

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[4] There is no evidence in the record to suggest that Secrist understood the trading he intended would itself be a violation of the law.

[5] Although Secrist had not said that Equity Funding's New York subsidary was involved in the fraudulent insurance practices, the New York staff made sure that the subsidiary's assets were intact (R. 6907-14).

Funding and EFLIC shared their principal offices.[6] California in turn quickly contacted insurance regulators in Illinois, who shared with California regulatory authority over EFLIC. By Friday, March 9, 1973—two days after Secrist had made his disclosures to the New York insurance authorities—California and Illinois had agreed to assemble a joint team of top insurance examiners to conduct an immediate investigation of Equity Funding[7] under the "guise of a routine examination" of EFLIC.[8]

On Monday, March 12, 1973, two Illinois examiners began an unannounced examination of EFLIC; a California examiner joined the investigation on March 22, 1973, delaying his arrival to make the examination appear routine (J.A. 87-88). The insurance examiners persisted in their investigation despite Equity Funding's attempts to thwart them.[9] They established that over $22 million of EFLIC's assets were missing, and on March 30, 1973, they seized control of EFLIC's operations and Equity Funding's scheme collapsed (J.A. 271; see also *id.* at 89; R. 10,798, 10,805-06).

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[6] The New York officials waited until the next day, March 8, 1973, to transmit the disclosures to the California authorities because they felt that Secrist had talked to them "in strict confidence" and his "permission," which was obtained on that date, was needed to inform others (J.A. 82).

[7] The California investigators were convinced that Secrist's allegations were entirely plausible, particularly since in their view there was "reason to question [the] integrity * * *" of Stanley Goldblum, the president of Equity Funding (J.A. 88; see also *id.* at 98-99). Similarly, Illinois officials found Secrist "rational" and "believable" when they met with him on March 21, 1973 (J.A. 86; R. 7089, 7102).

[8] A California official testified that the states used the pretext of a routine examination because they "didn't want to alert the company for fear that [it] might start destroying records" (J.A. 87).

[9] For example, Equity Funding officials tapped the telephone conversations of the examiners in an attempt to anticipate their investigative steps. The examiners quickly "suspect[ed their] telephone calls [were] being 'monitored'" (R. 12,639; see also R. 10,798), and began using pay telephones (R. 7727).

B. Secrist Informs Dirks, and Dirks Tips His Clients

On March 7, 1973, immediately after meeting with the New York insurance regulators, Secrist met with Dirks and an associate of Dirks who had been an actuary with a life insurance company. Secrist did not reveal that he had just met with the state insurance officials (J.A. 24). In a three-and-one-half-hour conversation Secrist gave Dirks and the associate the same detailed information he had just given to the state insurance authorities (J.A. 23, 192-94; R. 219-59, 479, 567). Secrist described the mechanics of the scheme, stating that he had witnessed and participated in creating bogus insurance files on fictitious policies (R. 224-35, 239-42, 254, 485-86, 525-37).[10] Secrist gave Dirks the names of several other Equity Funding insiders who would corroborate the information (J.A. 228; R. 248, 494-95). Dirks concluded that Secrist's detailed story "held together well under questioning by two insurance analysts" (R. 1642).[11]

At the end of the meeting, Secrist and Dirks spent 20 minutes discussing what Secrist expected Dirks to do with the report (R. 460). Secrist told Dirks his opinion of regulators, including the Commission, and his plan to have Dirks confirm the information and then disseminate it broadly to Dirks' clients (J.A. 15, 25-27).[12] Dirks suggested going to the *Wall Street Journal*

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[10] Secrist explained in detail how management had organized meetings to create fake insurance policy files (R. 239-42) and how employees had returned phony confirmation slips as part of the company's plan to deceive its auditors (R. 230-32). Secrist told Dirks that the insiders called bogus life insurance "Y business," a phrase coined by Art Lewis, EFLIC's chief accountant, after the mathematics symbol for the unknown (R. 237, 244, 441, 480).

[11] See also R. Dirks & L. Gross, *The Great Wall Street Scandal* 90-91 (1974) ("By the end of a four-hour lunch on March 7, it didn't sound all that crazy."). The administrative law judge found that Dirks believed at an early stage that Secrist's report was "probably true" (J.A. 258-60, 295) and that Dirks' contrary testimony was "less than candid" (J.A. 299-300).

[12] See Dirks & Gross, *supra* note 11, at 92.

("*WSJ*") with a view to having the newspaper investigate and publish a story exposing the fraud (J.A. 21-22, 27, 37-38). Dirks said he knew a *WSJ* reporter who "had good contacts with the regulators" (J.A. 37-38).

On Monday, March 12, Dirks quickly ascertained the identities of institutional investors he believed owned Equity Funding securities and began to convey to them the "hard story" about Equity Funding's fictitious insurance (J.A. 230-31; R. 1665-68). He told only a "soft story" about accounting irregularities, or nothing at all, to those who he believed did not own Equity Funding securities (J.A. 210-11, 219-21, 245; R. 4130-34, 4156-57, 4324-27, 4341-43, 4562-66, 4704-06).[13] The Boston Company Institutional Investors, Inc. ("Boston"), sold $1.2 million of its clients' Equity Funding securities based on Secrist's information tipped by Dirks (J.A. 189; R. 2088-2103, 2121-22, 2138-39, 2252-53, 5404-57, 11,451). Boston then directed brokerage business worth $4,000 to Dirks' firm as a direct result of the tip (J.A. 148, 199).[14]

When William Maloney, president of Institutional Capital Corporation, was tipped by Dirks, he asked why Dirks had not reported the information to the NYSE or the Commission; Maloney said that if Secrist's disclosures were true it would be "disastrous" and, if not, spreading the story through the investment community would cause a "tremendous" amount of needless "volatility in the stock" (J.A. 139). After receiving no "satisfactory answer," Maloney advised Dirks that Dirks should at least fly to Los Angeles and confront Equity

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[13] In this proceeding, reports of mere accounting irregularities "came to be known as the 'soft story' in contrast to the 'hard story' reports of widespread fraud involving bogus insurance, forged certificates of deposit, and related details" (J.A. 211 n.24).

[14] The administrative law judge found that this money was received "as a direct consequence of the fraud information," stating that contrary testimony "is not credited" (J.A. 263 and n.48; see also J.A. 199, 204-05).

Funding's management with the allegations (J.A. 140, 233-34).[15]

Dirks arrived in Los Angeles on March 20 and met with William Blundell, bureau chief in the *WSJ*'s Los Angeles office, whom he had alerted to the story (J.A. 233, 238; R. 8681-86).[16] Blundell began his own full-time investigation and quickly "became convinced that the story was true after talking to a couple of people * * * at Equity Funding who admitted * * * that they had engaged in various criminal action[s] and who emotionally broke down about this thing" (J.A. 131; R. 8702). By March 22 or 23, Blundell came to the conclusion that "the SEC ought to know about the information with an eye towards stopping trading in the stock" (J.A. 132).

Between March 20 and 23, Dirks independently interviewed the former and current Equity Funding employees who Secrist had said would corroborate his story.[17] All reported detailed, often first-hand evidence, confirming Secrist's report of widespread fraud at the company (J.A. 234-36, 239-42; R. 784-812, 990-1045, 1055-65).[18] Equity Funding's former controller, Frank Majerus, con-

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[15] Maloney also advised Dirks that Dirks might be violating the proscriptions on insider trading by spreading the information to institutional investors (J.A. 141-42; Pet. App. B17 n.33).

[16] Dirks had attempted to contact a reporter he knew at the *WSJ*'s San Francisco office on March 12, and reached him on March 19 (J.A. 230, 233; R. 780, 1248-49, 1259-60). In accordance with *WSJ* procedures, the story was assigned to Blundell in Los Angeles since Equity Funding was located there (J.A. 233; R. 8722).

[17] Dirks also met with a computer company employee who stated that based upon data he had acquired from Equity Funding's computer he would stake his career on the existence in 1970 of fictitious insurance (J.A. 241; R. 1087-89).

[18] The administrative law judge found that these other insiders confirmed that "the basic allegations of massive insurance fraud at Equity Funding were in fact true * * *," even though their stories contained "some peripheral contradictions" to Secrist's disclosures (J.A. 253 n.42, 260).

fessed to Dirks that he had falsified ledgers in 1970 to conceal the fictitious insurance, adding that he thought he would be "'going to jail'" for his participation in the fraud (J.A. 40, 236). Equity Funding's management denied Secrist's allegations.

From March 20 to March 23, 1973, Dirks continued to divulge the information privately to institutional investors that he knew or suspected owned Equity Funding securities. On March 20, he telephoned Boston, informing its officials of Majerus' confession (J.A. 237; R. 966). The following day, Boston sold its clients' remaining Equity funding holdings for $7.5 million and promised to direct brokerage business worth $25,000 to Dirks' firm (J.A. 237; 11,451). On March 22, 1973, Dirks spoke for 30 minutes with officials of The Dreyfus Corporation about Equity Funding's accounting of earnings, but he never mentioned the "hard story" regarding bogus insurance (J.A. 210-11; R. 4696-4701). After he ascertained that Dreyfus clients actually had Equity Funding holdings, on March 23 Dirks disclosed the "hard story" to Dreyfus (J.A. 211; R. 4562-66).[19]

On Friday, March 23, Blundell told Dirks that he had contacted the Commission about Equity Funding (J.A. 242; R. 1388). Although Dirks concluded that trading would soon be halted (J.A. 244-45), he did not try to contact any regulatory or law enforcement authorities himself.[20] Rather, over the weekend and on Monday, March 26, Dirks continued to supply inside information

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[19] Similarly on March 20 and 22, 1973, Dirks spoke with officials at Tomlin, Zimmerman and Parmelee, Inc., for more than an hour about a possible change in accounting for dividends that could have inflated Equity Funding's 1972 earnings, but he made no mention of the fictitious insurance (J.A. 219-20; R. 972-77). Dirks disclosed the "hard story" to Tomlin, Zimmerman and Parmalee on March 26, 1973 (J.A. 222-25; R. 453-55, 1912-14, 4178, 4364-67).

[20] On March 23, Dirks informed EFLIC's auditors, who decided to begin an "extended audit" of the company rather than to issue an opinion which they had been about to publish (R. 10,984; see also R. 7384).

about Equity Funding's true financial condition to institutional investors, which sold about $9 million of Equity Funding securities on Monday (J.A. 244-45; R. 1142-44, 1387, 3508-09, 4709-13, 11,451).

While Dirks now claims (Br. 12, 38) he was merely contacting "members of the investing community in an attempt to determine if the Secrist allegations could have any substance," there is no evidence he was seeking information from these institutions. When he spoke with personnel of John W. Bristol & Co., he did not seek information or assistance in investigating Equity Funding; he merely advised them that Equity Funding was engaged in fraud, that a halt in trading was imminent, and that if he were in their position " 'he would sell the stock' " (J.A. 207-08; see also R. 1142-44, 4932). When he spoke with officials at Fidelity Management and Research, Dirks did not even relate the report to them because they did not own Equity Funding stock (J.A. 47, 245; R. 1150-51). The administrative law judge found that Dirks' motive was to induce sales on the information and that Dirks acted in the "expectation and belief" that most of his tippees would sell their Equity Funding holdings (J.A. 294-95; see also J.A. 260). Blundell similarly concluded that Dirks' purpose in contacting institutional investors was to protect "some very important clients with a lot of stock," not to obtain information from "portfolio managers who didn't know beans about insurance operations" (J.A. 137-38).

C. Secrist's Information Finally Reaches the Commission

On Friday, March 23, Blundell told Stanley Sporkin, then the Commission's Deputy Director of Enforcement in Washington, D.C., that several Equity Funding employees had reported fraud at the company. According to Blundell, Sporkin stated that the Commission's staff would "get on it right then and sure enough that's what they did" (J.A. 133). The next business day, March 26, attorneys in the Commission's Los Angeles office interviewed Blundell (J.A. 134).

The following morning, March 27, they conducted extensive interviews with Dirks, Majerus, and another former Equity Funding employee (J.A. 164-65; see also Pet. App. B11). This was the first time the Commission obtained information comparable to that provided by Secrist to Dirks on March 7—that is, that a number of former employees knew of fraud at the company, could explain the mechanics of its operation, and were willing to assist in exposing the fraud (J.A. 269-70; see *infra* n.23).

Within a week, the Equity Funding scheme collapsed. On the morning of March 27, while the Commission was interviewing Dirks and the others, the *WSJ* reported in a brief note written by Blundell that "rumors" were circulating that questioned the accuracy of EFLIC's insurance in force and that Equity Funding had denied the rumors as "without foundation" (R. 11,605; see also J.A. 268, 271). Just after 12:30 p.m. Eastern Standard Time on that day, the NYSE halted trading in Equity Funding stock, amid heavy selling by Dirks' tippees and members of Equity Funding's top-level management who attempted to sell their stock before public revelation of the fraud.[21] The next day, Wednesday, March 28, the Commission suspended all trading in Equity Funding securities. As discussed previously, the state insurance regulators seized control of EFLIC's business operations two days later, on March 30, after discovering that over $22 million of EFLIC assets were missing. On the following Monday, April 2, Blundell published a detailed story in the *WSJ*, for the first time publicly exposing the existence of fictitious insurance (R. 11-608-10; see also J.A. 167).[22]

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[21] *Before the Fall: Many Officers Sold Equity Funding Stock Before Scandal Broke*, WSJ, April 20, 1973, at 1; see R. 10,811, 10,814.

[22] The administrative law judge found that "[t]he argument of some Respondents that they believed the inside information they had was already public knowledge is so lacking in support in the

The Commission filed an injunctive action the same day seeking the appointment of a new board of directors and a special investigator, which was ordered the following day (J.A. 167).[23]

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record as to come close to being frivolous" (J.A. 289; cf. *id.* at 143-45).

[23] Regrettably, there has been a misunderstanding as to when the Commission first received information comparable to that conveyed by Secrist to Dirks. In 1971, the staff of the Commission's Los Angles office was informed that William T. Mercado, a high-level Equity Funding officer, had made statements to the effect that the company was manipulating its earnings (J.A. 105, 270 n.49). The Commission's staff sought out Mercado and interviewed him. In contrast to the detailed story provided by Secrist to Dirks, Mercado "did not volunteer any information or come out with any statements regarding what was going on * * *" at the company (J.A. 114; see also *id.* 108, 270 n.49). Indeed, he effectively covered up the fraud. Mercado stated that, although he had noticed "several questionable accounting practices" at Equity Funding when he first joined the company, any accounting irregularities had occurred because the company had been founded by salesmen who did not have qualified accountants advising them and, "[s]ince then, * * * the corporation ha[d] employed qualified accountants" to ensure that it followed proper accounting practices (J.A. 157-58). Mercado assured the staff that, although he was leaving the company under circumstances he described as "not friendly," he had "no reason to believe" that the company was engaging in any questionable practices (J.A. 155-59).

Several months later, Mercado's attorney, James Jess, contacted the Commission's staff, assertedly because of his concern that Mercado might have been questioned improperly without the presence of an attorney (J.A. 160-62). Contrary to Dirks' assertion (Br. 6), the Commission did not reject "an offer" by Jess for Mercado "to provide information about substantial fraud at Equity Funding in exchange for immunity." Although that may have been Jess' plan before meeting with the staff, a contemporaneous memorandum of the meeting indicates that the subject of "immunity" was raised in a very circumspect manner and Jess never stated that Mercado had any information which he had not already supplied to the staff (J.A. 160). The staff contacted several employees other than Mercado, but no one offered information concerning improper practices (J.A. 107-08, 270 n.49).

On March 9, 1973, two days after Secrist had revealed his information to the New York authorities, an attorney with the California

3. *The Commission's Decision*

In its opinion below the Commission found that Dirks had aided and abetted violations of the antifraud provisions by causing sales of $17 million of worthless Equity Funding securities on the basis of material, inside information concerning Equity Funding's true financial condition.[24] The Commission stated that Dirks' tippees' use of material, inside information "in dealing with uninformed public investors constitute[d] an act, practice, or course of conduct which operate[d] as a fraud on investors" in violation of the antifraud provisions (Pet. App. B12). Dirks knew that the information he obtained was nonpublic (*id.* at B20) and he knew or should have known that his disclosures to the institutions would result in trading (*id.* at B22).

Department of Insurance advised a staff member of the Commission's Los Angeles office that an informant had alleged that the company was engaging in fraudulent insurance practices and that the state insurance agencies were going forward with the full investigation discussed previously (J.A. 91-98). The California attorney, who was not part of the team of insurance examiners looking into Equity Funding practices, did not go "into any special detail" about the reinsurance scheme and told the Commission staff member that he "wasn't sure of the name" of the informant, and "wasn't real sure of the fellow's job" (J.A. 94; R. 7717). Nevertheless, according to a contemporaneous memorandum of the meeting, the Commission staff member responded that California should "obtain as much detailed information as possible from the informant and that upon receipt of this information" the Commission and the state agencies would discuss an appropriate method of jointly investigating Equity Funding (J.A. 171-72; see also *id.* at 97). In the memorandum, the Commission's staff member suggested delaying the Commission's participation in the state insurance regulators' investigation only "*if* the informant cannot give detailed information" (J.A. 172 (emphasis supplied)).

[24] Section 15(b) of the Securities Exchange Act, 15 U.S.C. 78*o*(b), provides that the Commission may impose certain sanctions, including a censure, on any person associated with a registered broker-dealer, who has willfullly violated or "willfully aided, abetted, counseled, commanded, induced, or procured * * *" any violation of the federal securities laws.

The Commission found that the information Dirks tipped was material (*id.* at 14-20). The information was "specific and detailed," sharply contrasting with vague rumors that were publicly available in the marketplace, came from a known inside source, and, by March 23, 1973, had been repeatedly corroborated by "detailed, often first-hand" information from other Equity Funding insiders (*id.* at B14-15, B17). "Few disclosures," the Commission found, "could have had a greater impact on the quality of an investment, or on the stability of the market for it, and Dirks and his tippees clearly appreciated that fact" (*id.* at B17). The Commission found that the information was "clearly" and "unquestionably" material during the period from March 23 to March 26 (*id.* at B14-15). The Commission stated that petitioner's censure was warranted on the basis of the $9 million of trades that he fostered during that brief period alone (*id.* at B26 n.54).

The Commission stated that *Chiarella* v. *United States*, 445 U.S. 222 (1980), had confirmed the well-established principles that "corporate insiders" have a duty to disclose or abstain from trading in their corporation's securities on the basis of material inside information and that "tippees," such as Dirks and his clients, "who receive non-public, material information from insiders become 'subject to the same duty as [the] insiders'" (Pet. App. B11-12 & n.21, B21 n.42, quoting *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237 (2d Cir. 1974)). The Commission found that while Dirks' insider sources were presumably entitled to disclose the Equity Funding fraud in order to bring it to light and its perpetrators to justice, they could not profit secretly from trading with persons who were ignorant of the fraud (Pet. App. B20-21 & n.42). Petitioner "assumed" that duty from Secrist and the other Equity Funding insiders with whom he was dealing (*id.*).

The Commission expressed its full appreciation for the importance of the work of securities analysts in provid-

ing public investors with an accurate factual basis upon which to make their investment decisions. The Commission considered whether its decision would impair the efficiency of the securities markets or discourage securities analysts from actively researching corporations and, especially, investigating allegations of fraud (*id.* at B25-26). The Commission noted that "market efficiency" in the pricing of securities is an important statutory goal that is "significantly enhanced" by the activities of professional analysts in ferreting out and analyzing information relating to the value of securities (*id.* at B12-13). On the other hand, the Commission stated, promoting investor confidence in the fairness of our markets is also an important statutory goal that is significantly impaired when investors trade on material inside information disseminated to them directly or indirectly through analysts (*id.* at B25-26).

To accommodate these two goals—market efficiency and fairness—a line must be drawn (*id.* at B13). The proper line, the Commission explained, permits analysts to sell information they have "create[d]", but not to pass along to clients the type of information that their insider sources are themselves prohibited from using in securities trading (*id.* at B18):

> We have long recognized that an analyst may utilize nonpublic, inside information which in itself is immaterial in order to fill in "interstices in analysis." That process is legitimate even though such "tidbits" of inside information "may assume heightened significance when woven by the skilled analyst into the matrix of knowledge obtained elsewhere," thereby creating material information.

The Commission found that Dirks crossed the boundary of legitimate analysis into unlawful tipping (*id.*):

> [I]t is important to recognize that this is not a case in which a skilled analyst weaves together a series of publicly available facts and non-material inside disclosures to form a "mosaic" which is only material

> after the bits and pieces are assembled into one picture. • • • • •
>
> Secrist's information certainly was not "seemingly inconsequential data." Instead, its significance was immediately clear. Upon receipt of the information from Secrist, there was no need for Dirks to obtain, and he did not obtain, significant new facts to be woven together with Secrist's original allegations. All that occurred was corroboration and confirmation from inside sources of the original allegations.

The Commission concluded that under these circumstances a finding that Dirks aided the institutions in violating the antifraud provisions "will not discourage analysts from engaging in the legitimate and desirable function of seeking out corporate information" (*id.* at B19).

The Commission took into account, as mitigating factors, that Dirks had provided information about the Equity Funding fraud to the *WSJ*, to Equity Funding's auditors, and eventually to the Commission. The Commission determined that some sanction was nonetheless warranted because Dirks had privately advised the institutions of the fraud knowing that they would be able to "trade on the information well before it would become public" (*id.* at B26 n.52). The Commission determined to impose only a censure against him (*id.* at B26).[25]

4. *The Court of Appeals' Decision*

The court of appeals (Wright, Tamm, and Robb, J.J.) entered a judgment without accompanying opinion, denying, "for the reasons stated by the Commission in its opinion," Dirks' petition for review of the Commission's censure order (*id.* at C1-2).[26] Judge Tamm dissented from the judgment.

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[25] Censure is the mildest remedy available to the Commission under Section 15(b).

[26] The judgment also stated Dirks "breached his duty to the Commission and to the public not to misuse insider information and that he was compensated for so doing" (Pet. App. C1-2).

Subsequently, the court of appeals issued an opinion written by Judge Wright (*id.* at A1-41). Judge Robb concurred in the result, and Judge Tamm dissented; neither filed a separate opinion. Judge Wright stated that Dirks' censure should be affirmed on the theory expressed by the Commission that Dirks and his tippees had assumed the "disclose-or-abstain" obligations of their insider sources (*id.* at A15-27, citing *Shapiro* v. *Merrill Lynch*). Judge Wright added that, as an employee of a broker-dealer, Dirks breached ethical duties not to assist his "clients [in] dump[ing] fraudulent securities on an uninformed public" (Pet. App. A3, A27-31).

SUMMARY OF ARGUMENT

1. Dirks inherited the duty of the source of his information, Secrist, not to defraud purchasers of Equity funding securities. Secrist had a duty to disclose the company's true condition to investors before trading with them. That duty rests upon the common law fiduciary relationship between a corporate insider and the stockholders of the corporation rather than upon the separate and distinct duty of the insider to the corporation to preserve the confidentiality of corporate information. Thus, the fact that in this case the information concerning Equity Funding's fraudulent practices was not entitled to confidentiality is irrelevant to Secrist's continuing duty not to disadvantage the company's shareholders.

This Court recognized in *Chiarella* v. *United States*, in discussing the traditional prohibition against insider trading by insiders and their tippees, that the duty to disclose *inside* information arises not from any obligation to the corporate source of the information but from the "relationship between a corporate insider and the stockholders of his corporation." The Court's actual holding did not involve inside information. *Chiarella* held that "a duty to disclose under § 10(b) does not arise from mere possession of nonpublic *market* information." 445

U.S. at 235 (emphasis added). In sharp contrast to Secrist's status as an insider of Equity Funding, the source of the information obtained by Chiarella was not an insider but a proposed tender offeror, who had no fiduciary duty to the target company's shareholders with whom Chiarella traded. Thus there was no duty to be inherited by Chiarella.

In this case the Commission followed *Chiarella*. The Commission's analysis is supported by the common law principles recognized in that decision and by the language and purposes of the antifraud provisions of the federal securities laws. Congress confirmed that approach when in 1975 it comprehensively amended the securities laws.

a. At common law, an officer or director is "a quasi trustee" of the shareholders in his transactions in the shares of the company. *Oliver* v. *Oliver*, 118 Ga. 362, 367 (1903); *Stewart* v. *Harris*, 69 Kan. 498, 504 (1904). He is required to inform his shareholders of the corporation's true condition before trading with them in the corporation's stock, and his failure to do so is fraud. *Strong* v. *Repide*, 213 U.S. 426, 435 (1909). The character of the information, whether a legitimate corporate secret or evidence of crime, is irrelevant to this disclosure duty.

Since corporate officers and directors are forbidden by their trust relationship from using undisclosed corporate information to the disadvantage of their shareholders, they may not give such information to outsiders for the same improper purpose. Cf. *Mosser* v. *Darrow*, 341 U.S. 267, 272 (1951). "Tippees" who knowingly participate with the insiders in such a breach of fiduciary duty are "as forbidden" from taking advantage of shareholders as the insiders themselves. *Id.* Since the disclosure obligation of tippees rests upon the disclosure obligation of the insider to individual shareholders rather than any duty of silence or loyalty to the corporation, the corporation's right to preserve information as a secret is not a prerequisite to the tippee's liability.

Consistent with these common law principles, the Commission held that Dirks' insider sources had a duty to disclose Equity Funding's true financial condition to the company's investors before trading with them, notwithstanding the fact that the truth evidenced criminal conduct. By giving inside information to Dirks with the intent that Dirks and Dirks' tippees use that information to the detriment of Equity Funding investors, Secrist breached his fiduciary duty. As a knowing participant in that breach, Dirks assumed the duties of Secrist. Like Secrist, Dirks owed Equity Funding no duty of confidentiality and was free to report his inside information to any law enforcement authority. Like the insiders, however, he was duty bound not to pass that information on to favored institutions which would be likely to sell their worthless Equity Funding securities to uninformed investors.

b. In adopting Section 17(a) and Section 10(b), Congress embraced and built upon these common law fiduciary principles. Imposition of tippee liability on Dirks is consistent with the broad language of the antifraud provisions, and necessary to achieve Congress' purpose of eliminating the abuses of insider trading for the protection of investors and the maintenance of investor confidence in the integrity of the trading markets.

c. Congress has confirmed that the Commission has correctly interpreted its legislative intent. When Congress revisited the subject of informational advantages in the comprehensive Securities Acts Amendments of 1975, it left intact the consistent and widely-known Commission and judicial decisions holding that insiders and tippees are prohibited by the antifraud provisions from using inside information to the disadvantage of uninformed investors, whether or not the corporation is entitled to keep the information secret.

2. The public's interest in promoting effective law enforcement does not warrant the creation of an exception to the insider trading prohibitions for inside information

that evidences possible illegal conduct. First, such an exception would encourage tippees to withhold the information not only from persons with whom they trade but also from law enforcement authorities. Because information loses its value in the market when it is generally known, the "last thing that a man with information of Wall Street wants to do is make that information public." Dirks & Gross, *supra* n.11 at 282. The proposed exception thus runs afoul of the "deeply rooted social obligation" to report information evidencing criminal conduct to law enforcement officials, *Roberts* v. *United States*, 445 U.S. 552, 558 (1980), and the common law policy against permitting citizens to "convert [knowledge of] crime to a source of profit or benefit * * *." *Williams* v. *Bayley*, L.R. 1 H.L. 200, 220 (1866). Adoption of this exception would be more likely to impede, than to promote, effective law enforcement.

Second, the exception would lead to uncertainty. Tippees are in a poor position to distinguish criminal conduct from the many corporate activities that are within a broad "'gray zone of socially acceptable and economically justifiable business conduct,'" *Upjohn* v. *United States*, 449 U.S. 383 (1981), quoting *United States* v. *United States Gypsum Co.*, 438 U.S. 422, 440-41 (1978). Tippees would necessarily act at their peril in trading on the basis of such undisclosed information.

3. The Commission, the trier of fact, found that the information Dirks tipped was material—that is, that it would have been important to a reasonable investor in making an investment decision. *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976). The court of appeals held that the Commission's materiality finding was supported by substantial evidence, and that determination is conclusive absent extraordinary circumstances. *Universal Camera Corp.* v. *NLRB*, 340 U.S. 474, 491 (1951).

ARGUMENT

I. THE TRADITIONAL INSIDER TRADING PROHIBITION APPLIES TO DIRKS SINCE HE INHERITED THE DUTY OF THE EQUITY FUNDING INSIDERS NOT TO PARTICIPATE IN DEFRAUDING THE COMPANY'S INVESTORS; THAT THE TRADING IN THIS CASE WAS BASED ON INFORMATION RELATING TO CRIMINAL CONDUCT DID NOT OUST THAT PROHIBITION

It is well settled that a corporate insider's or tippee's failure to disclose material inside information before trading with investors is fraudulent conduct prohibited by Section 17(a) and Rule 10b-5. This insider trading prohibition comports with traditional fiduciary principles and serves to protect the integrity of the securities markets. The Commission applied this prohibition to Dirks. It held that Dirks, "standing in [the] shoes" of his insider sources, "committed a breach of the fiduciary duty which he had assumed in dealing with them, when he passed [inside] information on to traders" who, consistent with his expectations, sold worthless securities to uninformed investors (Pet. App. B21 n.42).

Neither Dirks nor the Solicitor General, who has filed a brief as amicus curiae in support of reversal on this issue, disputes the general applicability of the insider trading prohibition. Rather, they contend that there should be an exception from that doctrine here because the undisclosed inside information was evidence of crime instead of "[l]egitimate" inside information "properly kept confidential for the benefit of the corporation" (Dirks Br. 28; see *id.* at 22-23; S.G. Br. 24 n.16).[27] The requested exception is without foundation.

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[27] In addition to Dirks' attack on the Commission's duty analysis, which we discuss in the text, Dirks also attacks (Br. 31-34) Judge Wright's alternate theory that Dirks, as an employee of a broker-dealer firm registered with the Commission, had a special duty to disclose or abstain from trading. However, the Commission did not consider Judge Wright's alternate theory in its decision, nor did it present that theory to the court of appeals. Its merits are

Dirks and the Solicitor General erroneously rely on this Court's decision in *Chiarella* in making their argument. They concede that there is no conflict between the Commission's decision here and *Chiarella*'s actual holding, and this Court's recognition there of the insider trading principles supports the Commission's decision in this case. Moreover, there is nothing in the opinion even remotely suggesting that these principles should be ousted when the inside information shows criminal wrongdoing.

Chiarella did not involve inside information of any type. *Chiarella* held that "a duty to disclose under § 10(b) does not arise from mere possession of nonpublic *market* information"—that is, information originating outside the company and usually about the supply and demand for the company's securities. 445 U.S. at 235 (emphasis supplied). See also *id.* at 231 n.13. In *Chiarella*, the source of the information obtained by Chiarella was a prospective tender offeror, not the target company whose shares Chiarella traded. The tender offeror had no fiduciary duty to the target company shareholders

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therefore not before this Court. *SEC* v. *Chenery Corp.*, 332 U.S. 194, 196 (1947). The Solicitor General agrees (Br. 12-13 n.4) that in light of *SEC* v. *Chenery* "there is no need for the Court to consider this alternate theory of liability * * *."

Amicus Securities Industry Association ("SIA") limits its brief (Br. 19) to the argument that this Court should reject Judge Wright's alternative view. The SIA argues that Judge Wright's theory is incorrect because, among other reasons, it requires an analyst to disclose before trading or transmitting to his clients for their trading purposes material nonpublic information "[r]egardless of whether inside information is involved or the analyst has any nexus to the corporation or its insiders * * *." This position is consistent with the position that the SIA took as amicus curiae in *Chiarella*, where it argued that imposition of a general duty to disclose *market* information (see *infra* p. 22) would disrupt normal activities of securities professionals. However, the SIA in *Chiarella* had no quarrel with the proposition involved here that "traditional corporate insiders * * * or those who derive inside information from them, a class of persons as to whom the imputation of a duty to speak * * * is surely appropriate," may not profit on inside information. SIA Brief in *Chiarella* at 27-28.

to disclose its information before trading with them and was also free, under the law at the time,[28] to transmit the information to institutional investors for their trading purposes. 445 U.S. at 231, 232-33. Accordingly, there was no disclosure duty to be assumed or inherited by Chiarella. In sharp contrast, the sources of the information here did have a disclosure duty which could be inherited; they were Equity Funding insiders who owed a fiduciary duty to the company's investors to disclose, before trading with them, *inside* information—that is, information generated within the company relating to its assets or earnings. Indeed, Dirks and the Solicitor General do not dispute that Secrist and Dirks' other insider sources had a duty to investors to disclose the information involved here before trading with them, notwithstanding that it evidenced crime.

In relying on *Chiarella* to support their contention that the duty to disclose information evidencing a crime cannot be inherited, Dirks and the Solicitor General misread the decision. *Chiarella* discussed two separate doctrines under which a duty to disclose may arise. One, what might be called a "misappropriation" doctrine, imposes a duty to disclose information that has been obtained by theft or other misappropriation, even if the source of the information did not himself have any duty to those with whom he might trade. 445 U.S. at 239-43. Under that doctrine the fact that information evidences crime is arguably relevant on the theory that such information cannot be the "private property of anyone" or "amenable to 'conversion'" (S.G. Br. 22-23). The Commission did not, however, apply any misappropriation principle in this case.[29] The second doctrine was the

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[28] After *Chiarella*, the Commission promulgated Rule 14a-3(c) prohibiting certain kinds of trading on nonpublic information regarding upcoming tender offers. See *Chiarella*, 445 U.S. at 234 n.18; 45 Fed. Reg. 60410 (1980).

[29] The Commission agrees that a person who steals or misappropriates secret information that is material to the value of a publicly traded security should not be permitted to use that information in

traditional prohibition, discussed with approval by this Court in *Chiarella*, against trading on inside information. 445 U.S. at 226-30 & n.12. That doctrine, which imposes liability on both insiders and their tippees, is the basis of this case.

Under that doctrine, the fact that the inside information in this case evidences crime, and thus may not be subject to misappropriation, is irrelevant. The disclosure duty here does not rest on a breach of any obligation to the source of the information, but rather on an independent disclosure obligation to the investor who is buying or selling the security. The pervasive flaw in the argument advanced by Dirks and the Solicitor General is their failure to recognize that fundamental distinction.

Chiarella recognized that the duty to disclose inside information arises not from any obligation to the corporate source of the information but from the "relationship between a corporate insider and *the stockholders* of his corporation." 445 U.S. at 227 (emphasis supplied). When this Court mentioned that the tippee's obligation had been viewed as arising from his role as a participant in an insider's "breach of a fiduciary duty," it did not suggest that the beneficiary of that duty was the corporate entity. See 445 U.S. at 230 n.12. Likewise, when the Commission and the lower courts have considered tippee liability in their decisions, they have focused on the relationship between the insider and shareholder as the source of the duty to disclose inside information, and not on the corporate entity's right

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trading in the securities markets. The Court in *Chiarella* did not hold Chiarella liable under that doctrine since it had not been adequately presented to the jury in that criminal case. 445 U.S. at 235-37; see also 445 U.S. at 238 (concurring opinion); 445 U.S. at 239 (concurring opinion); 445 U.S. at 239-43 (dissenting opinion); 445 U.S. at 243-45 (dissenting opinion).

The Commission in this case did not premise liability on a theory that Dirks used the information beyond the purpose intended by Secrist. In an appropriate case, misuse of information given for a limited purpose would be a form of misappropriation.

or interest in preserving the information as a secret. See *infra*, p. 36.

In this case, the Commission followed *Chiarella*. While Equity Funding had no right to keep secret the information that it had fraudulently inflated its reported assets and earnings, that circumstance was not relevant to an insider's or tippee's duty to disclose before trading with Equity Funding investors. As the Commission stated:

> It is one thing to relieve a corporate insider of his duty of confidentiality to the extent necessary to inform the proper authorities where improper or illegal conduct is taking place within the corporation. It is, however, quite another matter to allow the insider to profit by trading on the information himself—or to allow the insider's tippee to divulge it to those who may trade or tip traders.

Pet. App. B20-21. The Commission thus found that Dirks assumed a fiduciary duty running to Equity Funding investors when he knowingly received from the company's insiders nonpublic inside information and that he committed a breach of that duty "when he passed the information on to traders" expecting them to trade (*id.* at B21 n.42).

A. The common law antecedents of the antifraud provisions support the Commission's decision

Since the language of Section 17(a) and Section 10(b) does not explicitly address when nondisclosure is fraudulent (see *Chiarella*, 445 U.S. at 226), it is appropriate to look to the common law antecedents of these provisions to ascertain the meaning of the language chosen by Congress. Under the common law principles recognized in *Chiarella*, a corporate insider owed a fiduciary duty to individual shareholders with whom he traded to disclose all corporate information that would be important to their investment judgment about the company's securities. He also owed a duty to his corporation not to misappropriate its assets or breach its legitimate confidences.

These two sets of duties are distinct. The duties running to the corporation protect its interest in preserving its assets, while the duties running to the shareholders protect their personal interests in their stock. The insider defrauds the shareholder[30] by failing to disclose inside information to him before dealing with him in the stock, regardless of whether the corporation has an interest, legitimate or illegitimate, in maintaining the confidentiality of the information or whether the information is a corporate asset capable of being misappropriated. The tippee's disclosure duty rests upon the insider's duty of disclosure to his shareholder, not upon any duty of silence owed to his corporation.

1. Prior to 1900, the common law regarded corporate officers and directors as standing in a fiduciary relation to their corporation in their dealings with corporate property, but not to stockholders in their transactions in the corporation's stock. As agents of the entity, corporate officers and directors owed their corporation fiduciary duties to preserve its assets and to maintain its secrets. See generally 2 J. Pomeroy, *Equity Jurisprudence* §§ 1088-94 (2d ed. 1892); *Restatement (Second) of Agency* § 395 (1976); *Restatement of Restitution* § 200 comment a (1936). They were not precluded by their fiduciary duties to their corporation from trading in the corporation's stock on the basis of nonpublic corporate information, since, as a general matter, such information was not considered a corporate asset or opportunity. See 2. J. Pomeroy, *supra*, at § 1090.[31] Since officers and directors

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[30] Under the securities laws, this principle applies to prospective shareholders as well, *i.e.*, purchasers. See *infra* n.40.

[31] As late as 1949, the Delaware Court of Chancery remarked that, "in the absence of special circumstances, corporate officers and directors may purchase and sell its capital stock at will, and without any liability to the corporation." *Brophy* v. *Cities Services Co.*, 31 Del. Ch. 241, 245, 70 A.2d 5, 8 (1949). A "special circumstance" arises, for example, when the corporation intends to purchase its own stock secretly and the officer or director learns of that intention in the course of his relationship with the corporation; in such

did not stand in a fiduciary relation to individual shareholders, they were free to trade with shareholders without disclosing nonpublic information affecting the value of their stock. See *Walsh* v. *Goulden*, 130 Mich. 531, 539, 90 N.W. 406, 410 (1902); *Board of Commissioners* v. *Reynolds*, 44 Ind. 509, 513, 516 (1873); Cary, *Corporations* 700-02 (4th ed. 1969).[32]

In 1903 and 1904, the Supreme Courts of Georgia and Kansas first recognized an independent fiduciary duty

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a case, the officer's or director's use of the information is adverse to the corporation's interest in acquiring stock cheaply. *Brophy*, 31 Del. Ch. at 245, 70 A.2d at 8. See also *Freeman* v. *Decio*, 584 F.2d 186, 196 (7th Cir. 1978) (corporation has no right of action for insider trading under Indiana law); *Schein* v. *Chasen*, 313 So. 2d 739, 746 (Fla. 1975) (same under Florida law), following certification after remand in *Lehman Brothers* v. *Schein*, 416 U.S. 386 (1974), which vacated *Schein* v. *Chasen*, 478 F.2d 817 (2d Cir. 1973); Brudney & Clark, *A New Look At Corporate Opportunities*, 94 Harv. L. Rev. 997, 1014-15 (1981). In 1969, well after the Commission and the courts had developed the insider trading principles involved here, the New York Court of Appeals recognized a corporation's right to sue insiders who trade on nonpublic corporate information. *Diamond* v. *Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910 (1969). *Diamond* has not been adopted by any other state. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 Mich. L. Rev. 1051, 1070 n.50 (1982).

Dirks erroneously contends (Br. 26 and n.14) that the Commission's decision in this case is "sharply at odds" with *Walton* v. *Morgan Stanley & Co.*, 623 F.2d 796 (2d Cir. 1980). *Walton*, however, merely follows the common law principle that, except in special circumstances, a corporation has no right of action to recover profits made from use of inside information in transactions with the company's investors. *Walton*, an action brought on behalf of the corporation itself, did not consider whether a recipient of such information owes a duty of disclosure to those with whom he trades.

[32] As the Supreme Court of Washington summarized the law, " '[t]he doctrine that officers and directors are trustees of stockholders applies only in respect to their acts relating to the property or business of the corporation. It does not extend to their private dealings with stockholders or others, though in such dealings they take advantage of knowledge gained through their official position.' " *O'Neile* v. *Ternes*, 32 Wash. 528, 541, 73 P. 692, 696-97 (1903) (quoting 21 American & English Encyclopedia of Law 898 (2d ed.)).

running from the corporate officers and directors to individual shareholders with whom they traded in the corporation's stock. *Oliver* v. *Oliver*, 118 Ga. 362, 45 S.E. 232 (1903); *Stewart* v. *Harris*, 69 Kan. 498, 77 P. 277 (1904). These courts held that an officer or director is "a quasi trustee as to the shareholder's interest in the shares." *Oliver*, 118 Ga. at 367, 45 S.E. at 234; see *Stewart*, 69 Kan. at 504, 77 P. at 279. They held that, while he is not forbidden to deal with shareholders, an officer's or director's relationship of trust requires him to "inform such stockholders of the true condition of the affairs of the corporation" before trading with them. *Stewart*, 69 Kan. at 508, 77 P. at 281; see *Oliver*, 118 Ga. at 367-68, 45 S.E. at 234. By 1909, this Court had adopted this fiduciary principle, setting aside a purchase of stock by a director on the ground that he had failed to disclose to the shareholder-seller material facts bearing upon the value of the stock. *Strong* v. *Repide*, 213 U.S. 419, 431-35. This Court described the director's silence as "fraud" in "legal effect." 213 U.S. at 435.[33]

These early decisions make clear that the insider's fiduciary duty running to shareholders is distinct from his fiduciary duties to his corporation. The Supreme Court of Georgia explained the relationship between these two duties:

> It might be that the director was in possession of information which his duty to the company requires him to keep secret; and if so, he must not disclose the fact even to the shareholder, for his obligation to the company overrides that to an individual holder

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[33] Recognition of a right of action by a defrauded shareholder did not alter the law that the corporation could not recover for an insider's use of nonpublic information absent some tangible injury to it resulting from the insider's trades: " 'the directors and managing officers occupy the position of *quasi*-trustees toward the stockholders alone, and not at all towards the corporation, with respect to their shares of stock.' " *Stewart* v. *Harris*, 69 Kan. at 504, 77 P. 279, quoting 2 J. Pomeroy, *Equity Jurisprudence* § 1090 (2d ed. 1892).

> of the stock. But if the fact so known to the director cannot be published, it does not follow that he may use it to his own advantage, and to the disadvantage of one whom he also represents. * * * If, however, the fact within the knowledge of the director is of a character calculated to affect the selling price, and can, without detriment to the interest of the company, be imparted to the shareholder, the director, before he buys, is bound to make a full disclosure.

Oliver, 118 Ga. at 368, 45 S.E. at 234. Therefore, an insider cannot defend his nondisclosure to a shareholder by arguing that a duty of silence was owed the corporation. Nor can he argue that the information was not a corporate secret and could have been obtained by the shareholder if he had merely asked. *Stewart*, 69 Kan. at 508, 77 P. at 281.

Consistent with these principles, the Commission correctly determined that whether Equity Funding was entitled to keep the information confidential was irrelevant to the insider's duty to disclose that information before trading with shareholders. While Equity Funding insiders in this case owed no duty of silence to Equity Funding, they did owe a duty of disclosure to the company's shareholders which prevented them from selling worthless stock to the shareholders without disclosure of the true financial condition of the company. As the Solicitor General agrees (Br. 19 n.12),

> regardless of the classification of information as inside information * * * or evidence of crime, a fiduciary would not be permitted to take advantage of uninformed beneficiaries by dealing with them in securities transactions. For example, Ronald Secrist and the other officers and employees of Equity Funding were disabled from profiting at the expense of shareholders without full disclosure.

Thus, Secrist could not have sold $17 million of Equity Funding shares, even if his stated purpose was to alert the regulators as a result of the market impact of his

sales and his $17 million profit was said to be only a by-product of his service to society.

2. Just as Secrist could not trade, his tippee Dirks could not trade, and Dirks' tippees could not trade. If officers and directors are forbidden by trust principles from using undisclosed corporate information to the disadvantage of their shareholders in stock transactions, they may not provide such information to others to victimize the shareholders. "[T]hat which the trustee has no right to do he has no right to authorize." *Mosser* v. *Darrow*, 341 U.S. 267, 272 (1951). Further, the transactions of all who knowingly participate with the trustee in such a breach are "as forbidden" as transactions "on behalf of the trustee himself." *Id.*[34] As the Court explained in *Mosser*, a contrary rule "would open up opportunities for devious dealings in the name of the others that the trustee could not conduct in his own." 341 U.S. at 271. See also *SEC* v. *Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir.) ("[W]ithout such a remedy, insiders could easily evade their duty to refrain from trading on the basis of inside information. Either the transactions so traded could be concluded by a relative or an acquaintance of the insider, or implied understandings could arise under which reciprocal tips between insiders in different corporations could be given."), cert. denied, 404 U.S. 1005 (1971).[35]

Under these principles, an insider violates a fiduciary duty to the corporation's shareholders by transmitting

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[34] See also *Jackson* v. *Smith*, 254 U.S. 586, 589 (1921) (all who knowingly participate with a trustee in a breach of duty toward the trustee's beneficiary are jointly and severally liable to the beneficiary for all their profits); *Jackson* v. *Ludeling*, 88 U.S. 616, 629, 631 (1874) (outsiders who join corporate insiders in a breach of duty are liable to shareholders); *Restatement (Second) of Agency* §§ 387, 391 (an agent cannot help another take advantage of his principal).

[35] The language in the text from *Texas Gulf Sulphur* related to the court of appeals' affirmance of an order imposing liability on a tippor for the amount of his tippee's profits. 446 F.2d at 1306, 1308.

nonpublic corporate information to an outsider when he has reason to believe that the outsider will take advantage of the shareholders. The outsider who uses the nonpublic information by trading with a shareholder is a participant in the insider's breach of duty to the shareholder, and thus violates his inherited obligation to the shareholder when he is on notice that the insider is himself disabled from using the information without disclosure.

The present case falls within these principles. Secrist was disabled by these trust principles—carried forward and strengthened in the federal securities laws (see *infra* p. 32)—from using his knowledge of material facts concerning Equity Funding's true financial condition in securities transactions with investors, and Dirks was on notice of this disability. Further, as Dirks and the Solicitor General concede, Secrist intended Dirks and his clients to use the information he gave them to the disadvantage of purchasers of Equity Funding securities (Dirks Br. 25 n.13; S.G. Br. 24).[36] Thus, regardless of any ultimate motive to bring to public attention the derelictions at Equity Funding, Secrist breached his duty to Equity Funding shareholders.

Standing in Secrist's shoes, Dirks owed no duty to Equity Funding to maintain the confidentiality of corporate information that evidenced criminal conduct. He was free to transmit the information to the FBI, the Commission, the NYSE or any other law enforcement authority, although he did not do so. But like Secrist, who violated his fiduciary duty in giving Dirks the information, Dirks was forbidden to "pass[] the information on to traders" with the expectation of their trading, and that is exactly why he was censured (Pet. App. B21 n.42).

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[36] The Solicitor General states (Br. 24) "the record establishes unequivocally that [Dirks] used the information in precisely the manner intended by [Secrist] * * *—to divulge the information to institutional traders who would precipitate large-scale market activity * * *."

B. The language of the antifraud provisions supports the Commission's decision

In enacting Section 17(a) and Section 10(b), Congress intended to adopt and build upon the foregoing common law developments. *Herman & MacLean* v. *Huddleston*, No. 81-680 (U.S. Jan. 24, 1983) slip op. 13 ("an important purpose of the federal securities laws was to rectify perceived deficiencies in the available common law protections"); *Foremost-McKesson, Inc.* v. *Provident Securities Co.*, 423 U.S. 232, 255 (1976); *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).[37] Congress drafted these provisions broadly to prohibit any species of fraudulent nondisclosure, including the fraudulent practices by insiders and their tippees discussed above. As this Court recently again emphasized, the securities laws combating fraud should be construed broadly to effectuate their remedial purposes. *Herman & MacLean*, slip op. 10-11.

Just as nothing in the common law suggests that violation of a corporation's business or property interests is a prerequisite to insider or tippee liability, nothing in the language of Section 17(a) or Section 10(b) suggests such a requirement. Section 17(a)(3) of the 1933 Act makes it unlawful for "any person," "directly or indirectly," "to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser" of a security. This language focuses "upon the *effect* of particular conduct on members of the investing public * * *." *Aaron* v.

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[37] See also *United States* v. *Naftalin*, 441 U.S. 768, 775 (1979); *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972); *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963); H.R. Rep. No. 1383, 73d Cong., 2d Sess. 5 (1934) (The "constant extension of the legal conception of a fiduciary relationship—a guarantee of 'straight shooting'—supports the constant extension of mutual confidence which is the foundation of a maturing and complicated economic system * * *.").

SEC, 446 U.S. 680, 697 (1980) (emphasis in original). Section 10(b) and Rule 10b-5 thereunder make it unlawful for "any person" to use or employ "directly or indirectly" any "deceptive device or contrivance" in the purchase or sale of any security. This language covers all frauds touching on securities transactions.[38] Nothing in the language of these provisions conditions an insider trading violation on the infringement of some legitimate interest of a nontrading corporate issuer.

C. The Commission's interpretation is consistent with Congress' purpose in enacting the antifraud provisions and has been confirmed by Congress

1. The Commission's decision not only finds support in the common law and the language of the antifraud provisions themselves, but also effectuates the purposes of the securities laws.[39] The Securities Exchange Act was designed "to prevent inequitable and unfair practices" (15 U.S.C. 78 (preamble)) and "to insure the maintenance of fair and honest markets" in securities transactions, Section 2, 15 U.S.C. 78b. One objective was to curb the misuse of inside information which in Congress' view had eroded investor confidence in the securities markets and thus capital formation. See S. Rep. No. 792, 73d Cong., 2d Sess. 3 (1934) ("The unfair methods of speculation employed by * * * those possessing inside information regarding corporate affairs * * * have also been contributing causes of losses to investors."); accord *id.* at 9; H.R. Rep. No. 1383, 73d Cong., 2d Sess. 11, 13 (1934). Congress relied in large measure on the general antifraud provisions at issue here to prohibit use of inside information. See *Foremost-McKesson, Inc.*, 423 U.S. at 255.

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[38] *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971).

[39] A Commission interpretation like the present one, which is compatible with the text and purpose of the securties laws, is entitled to deference. See *E.I. du Pont de Nemours & Co.* v. *Collins*, 432 U.S. 46, 54-55 (1977); *United States* v. *National Association of Securities Dealers, Inc.*, 422 U.S. 694, 718-19 (1975).

Congress' purposes fully support the Commission's conclusion that in knowingly receiving material inside information from Secrist, Dirks became subject to the same duty as Secrist. Under his own view of the facts, Dirks participated in a breach of Secrist's fiduciary duty to Equity Funding investors when he carried out Secrist's plan of inducing large sales of worthless securities to those investors on the basis of inside information.[40] As we have discussed, Dirks would be liable under these circumstances even under common law principles, and certainly under the federal securities laws.[41]

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[40] Although Dirks' tippees sold Equity Funding stock to purchasers who may not already have been shareholders (J.A. 245-46), this fact is not significant. In the words of Judge Learned Hand, " 'the director or officer assume[s] a fiduciary relation to the buyer by the very sale; for it would be a sorry distinction to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary although he was forbidden to do so once the buyer had become one." *Chiarella*, 445 U.S. at 227 n.8, quoting *Gratz* v. *Claughton*, 187 F.2d 46, 49 (2d Cir.), cert. denied, 341 U.S. 920 (1951). Moreover, the antifraud provisions protect "purchasers" and "sellers."

[41] Dirks would be liable even if he had obtained the information from Secrist for a proper, non-trading purpose (and thus without a breach of fiduciary duty by Secrist) and thereafter used the information to the disadvantage of Equity Funding investors. The Commission's opinion properly drew no distinction between the two situations, holding that a person who knowingly receives material corporate information in his dealings with insiders becomes " 'subject to the same duty as [the] insiders' " (Pet. App. B21 n.42, quoting *Shapiro*, 495 F.2d at 237).

To recognize such a distinction would nullify Congress' purpose of prohibiting "those possessing inside information regarding corporate affairs" from using that information to the detriment of public investors. S. Rep. No. 792, *supra*, at 3. If insider trading liability did not exist when the information was transmitted for a proper purpose but used wrongfully, it would be a rare situation when the parties could not fabricate some ostensibly legitimate business justification for transmitting the information. A rule against tippee trading in this context is thus necessary to " 'make securities regulation and control reasonably complete and effective.' " *Herman*

It is unimportant from the perspective of Congress' purpose whether the inside information is properly entitled to confidentiality. Since Congress intended to protect purchasers and sellers of securities, not the issuer corporation, from the evils of the use of inside information, the corporation's interest in keeping inside information confidential is simply irrelevant.

2. The principles relied upon by the Commission have been confirmed by Congress. When Congress comprehensively revised the securities laws in 1975,[42] a consistent line of administrative and judicial decisions had established, as a widely-known tenet of the securities laws, that any person knowingly receiving nonpublic corporate information from an insider is prohibited from using that information in trading with the corporation's investors. These decisions did not turn on whether the in-

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& MacLean, slip op. 10, quoting Section 2 of the Securities Exchange Act, 15 U.S.C. 78b.

As the Solicitor General recognizes, *Chiarella* did not attempt to limit tippee liability to circumstances in which the tippee receives inside information through a breach of the insider's fiduciary duty. Br. at 15 n.6, citing *SEC* v. *Lund*, [1981-1982] Fed. Sec. L. Rep. (CCH) ¶ 98,428 (C.D. Cal. Jan. 22, 1982).

[42] This Court noted in *Herman & MacLean*, slip op. 9, that the Securities Acts Amendments of 1975 constituted the " 'most substantial and significant revision of this country's Federal securities laws since the passage of the Securities Exchange Act in 1934' ", quoting Securities Acts Amendments of 1975: Hearings on S. 249 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 1st Sess. 1 (1975).

The 1975 amendments were based upon a comprehensive 10-year examination of the need for change in the federal securities law. See H.R. Rep. No. 123, 94th Cong., 1st Sess. 46 (1975); H.R. Rep. No. 229, 94th Cong., 1st Sess. 91 (1975) (Conference Report); *Securities Acts Amendments of 1975, Statement by the President on Signing the Bill into Law*, 11 Weekly Comp. Pres. Doc. 600, June 5, 1975.

formation had a positive or negative impact on the price of the securities or on whether the corporation had any right to maintain the confidentiality of the information.

These leading tippee decisions recognized that selective dissemination of corporate information that is material to the value of the corporation's stock is improper because it violates a duty running to the shareholders, not because it violates some corporate interest or expectancy in secrecy. For example, in the seminal tippee case, *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), the Commission held that a partner in a brokerage firm violated Section 17(a) and Section 10(b) when he sold stock after a director of the issuer told him that his company was about to announce a reduction in its quarterly dividend. The company did not regard that negative information as a corporate asset or a corporate secret; indeed, it had already transmitted the information to Western Union for dissemination when the partner traded. 40 S.E.C. at 909. In *Investors Management Co.*, 44 S.E.C. 633, 635 (1971), and *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 44 S.E.C. 933 (1971), the Commission held liable under the antifraud provisions a broker-dealer tippor and its institutional-investor tippees which sold stock based upon nonpublic negative earnings information that the broker-dealer had received in its capacity as a prospective underwriter for the issuer. As in *Cady, Roberts*, the negative information had no value to the corporation. Indeed, the issuer publicly disclosed the information three days after it had been transmitted to the prospective underwriter. 44 S.E.C. at 636. *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, involved the same negative earnings information that was involved in the Commission's *Investors Management* and *Merrill Lynch* decisions. The Second Circuit held that when the tippee knows "the confidential corporate source of the * * * information and * * * its nonpublic nature, [he is] under a duty not to trade in [the issuer's] stock without publicly disclosing such information." 495 F.2d at 238.

Prior to 1975 Congress directed comprehensive studies covering the subject of informational advantages.[43] As a result of these studies, Congress was advised that the antifraud provisions had been interpreted as prohibiting "*any* person from engaging in securities transactions on the material [inside] corporate information, if the information has not been publicly disclosed." *Institutional Investor Study Report of the Securities and Exchange Commission*, H.R. Doc. No. 62, 92d Cong., 1st Sess. 2538 (1971) (emphasis in original). These studies contained detailed discussions of the Commission's decisions in *Cady, Roberts; Merrill Lynch;* and *Investors Management.* See *Institutional Investor Study* 2538-39.

When Congress revisited the subject of informational advantages in the Securities Acts Amendments of 1975, it reaffirmed that ensuring that "dealing in securities is fair and without undue preferences or advantages among investors" is one of the "basic goals" of the federal securities laws. H.R. Rep. No. 229, 94th Cong., 1st Sess. 91 (1975) (Conference Report). Based upon the prior studies that it had directed,[44] Congress left intact the Commission's interpretation that the antifraud provisions prohibited all knowing recipients of material inside information from using such information to the disadvantage of uninformed investors. It also strengthened and expanded regulation of the use of market information, adding specific legislation that granted the Commission authority to control use of market information by stock exchange members. See Section 11(a) of the

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[43] See *Institutional Investor Study Report of the Securities and Exchange Commission*, H.R. Doc. No. 62, 92d Cong., 1st Sess. (1971); *Special Study of Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess. III (1963); *id.* at 157-60.

[44] The Securities Acts Amendments of 1975 "follow[] and reflect[] the conclusions of a long line of studies of our capital markets beginning in the early 1960s," including the *Institutional Investor Study*. H.R. Rep. No. 123, 94th Cong., 1st Sess. 46-47 (1975).

Securities Exchange Act.[45] Congress' decision to leave "intact" the traditional insider trading doctrine, while reshaping the law in the area of informational advantakes in other respects, is strong evidence that it "ratified" the existing administrative and judicial interpretation of the law on insider trading. *Herman & MacLean*, slip op. 9-10; see also *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran*, No. 80-203 (May 3, 1982) slip op. 24, 28.

II. NO POLICY JUSTIFICATION HAS BEEN SHOWN FOR THIS COURT TO CREATE AN EXCEPTION TO PERMIT INSIDER TRADING ON INFORMATION CONCERNING CRIMINAL WRONGDOING

Dirks (Br. 28-31) and the Solicitor General (Br. 26-30) have not carried the burden of their argument for an exception to the rules against insider trading on the supposition that application of those rules to information about crime will adversely affect criminal law enforcement and the customary functions of securities analysts. They assume incorrectly that law enforcement officials in this case did not act quickly enough[46] and ask this Court

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[45] See also H.R. Rep. No. 123, 94th Cong., 1st Sess. 55 (1975); S. Rep. No. 75, 94th Cong., 1st Sess. 67-69 (1975).

[46] As we have shown in the factual statement, once the regulatory authorities had the detailed information Dirks possessed, they took prompt steps to protect investors and policyholders and put a stop to the fraud. This suggests that the three-week period during which Dirks kept the information from the authorities delayed the eventual corrective actions and public disclosure of the fraud. Thus, Dirks' argument that the sales he fostered were the sine qua non of the termination of the fraud is not supported in the record and must be rejected.

His argument also ignores the "Ponzi-like" nature of the scheme. After an exhaustive examination of the company's affairs, Equity Funding's trustee concluded that the company's fraud was not a brilliant computer fraud that "baffled the world" but simply a "hand-to-mouth" scheme that avoided "detection as long as it did mainly because of audacity and luck" (R. 10,837-41). California's Chief Deputy Insurance Commissioner likewise testified that "[t]he

to provide a rule that would permit tippees like Dirks to profit from inside information about possible illegal conduct without reporting that information to law enforcement officials. As we demonstrate, such an exception, which would run afoul of deeply embedded common law traditions, would encourage insiders and tippees to withhold information from law enforcement authorities. Similarly, they have not shown that the Commission's decision in this case will inhibit analysts' customary research functions or impair market efficiency.

Concealing knowledge of crime from law enforcement authorities, as the Solicitor General acknowledges (Br. 23), has been condemned throughout our history. *Roberts* v. *United States*, 445 U.S. 552, 557 (1980); *Branzburg* v. *Hayes*, 408 U.S. 665, 697 (1972). Under the common law, all citizens had an affirmative duty to report facts about a felony to government authorities or be guilty of misprision of a felony.[47] The common law imposed this duty to prevent private citizens from taking the law into their own hands. See 2 W. Holdsworth, *History of English Law* 99-102 (3d ed. 1927). For the same reasons, failures to report crime to the authorities are still disfavored and persons are rarely excused from the "deeply rooted social obligation" to transmit such information to

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house of cards began to collapse because the logistics were too difficult to manage" (R. 12,424). The scheme "would finally have collapsed of its own mushrooming weight and the fumblings of its perpetrators * * *." M. Comer. *Corporate Fraud* 185 (1977), quoting Blundell, *Equity Funding Trustee Calls the Fraud Inept, Slapdash, and Assails the Auditors*, WSJ, November 4, 1974. When viewed against these realities, the record does not support Equity Funding's convicted president Stanley Goldblum's testimony that without Dirks the fraud might have continued. See M. Comer, *supra*, at 205 ("Thieves, particularly if they have been successful for a long time, may become arrogant enough to believe they are too clever to get caught.").

[47] *Sykes* v. *Director of Public Prosecutions*, [1961] 3 W.L.R. 371, 384-85, 391; see Statute of Westminster First, 3 Edw., c.9 (1275); Statute of Westminster Second, 13 Edw., c.6 (1285); cf. 18 U.S.C. 4.

the officials charged with protecting the public interest.[48] More importantly in the context of this case, the common law forbade citizens from profiting by their secret knowledge of illegal conduct. As Lord Westbury stated in voiding a contract not to report a crime,

> [i]t is a law dictated by the soundest consideration of policy and morality, that you should not make a trade of felony. *If you are aware that a crime has been committed, you shall not convert that crime into a source of profit or benefit to yourself* * * *. If men were permitted to trade upon their knowledge of a crime, and to convert their privity to that crime into an occasion of advantage, no doubt a great legal offence and a great moral offence would be committed.[49]

Creating a special rule to allow insiders and tippees to profit from their knowledge of illegal corporate activity runs afoul of these principles and would more likely impede than guarantee prompt disclosure of crime to public officials. As Dirks himself conceded, "[t]he last thing a man with information on Wall Street wants to do is make that information public." *The Great Wall Street Scandal*, *supra* note 11, at 282. Information begins to lose value in the stock market as it begins to become public; the analyst's true incentive is to keep information secret,

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[48] *Roberts*, 445 U.S. at 558; *see Branzburg*, 408 U.S. at 697-08. This Court has forcefully rejected the notion that persons with information relevant to the commission of crime may be excepted from the requirement that they "plac[e] their trust" in public officials because they wish to make their knowledge public in another manner. *Branzburg*, 408 U.S. at 695.

[49] *Williams* v. *Bayley*, L.R. 1 H.L. 200, 220 (1866) (emphasis added). See also *Sykes* v. *Director of Public Prosecutions*, [1961] 3 W.L.R. 371, 383 (concealment and profit are essential elements in compounding a felony). Most states have adopted this policy in their criminal laws by prohibiting profiting from agreements not to report crime. Note, *Compounding Crimes: Time for Enforcement*, 27 Hast. L.J. 175, 187-88 (1975); see, e.g., Cal. Penal Code 153 (West 1970).

at least until his clients have had the opportunity to profit from it.[50] Indeed, the "soft story" that Dirks gave to those who did not own Equity Funding stock see supra n.13, suggests that he did not intent to disseminate the fraud information "as broadly as possible" (R. 460-62) and belies the notion that permitting trading on inside information about crime will promote detection of criminal conspiracies.[51]

Moreover, since neither Dirks nor the Solicitor General provides a workable standard as to when trading on information evidencing criminal conduct may take place, the exception they propose could well lead to uncertainties in the securities markets. As this Court has observed, in the corporate world what may appear initially to be criminal conduct may actually be within a broad " 'gray zone of socially acceptable and economically justifiable business conduct' " and thus entitled to confidentiality. *Upjohn Co.* v. *United States*, 449 U.S. 383, 392-93 (1981), quoting *United States* v. *United States Gypsum Co.*, 438 U.S. 422, 440 (1978). If Dirks and the Solicitor General are suggesting a theory permitting trading on inside information only about conduct that is later adjudicated to be criminal, such a rule would be perilous for both the ordinary investor and the securities professional prospectively to apply. Alternatively, to permit trading on the basis of any inside information that arguably suggests illegal conduct would open the markets to massive trading on inside information. Indeed, under the broad exception proposed by Dirks and the Solicitor General, tippees might be free to trade on information

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[50] See Ferber, *The Case Against Insider Trading: A Response to Professor Manne*, 23 Vand. L. Rev. 621, 623 (1970); Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 Va. L. Rev. 1425, 1448-49 (1967).

[51] Although Dirks states that neither he nor his firm traded in Equity Funding stock (Br. 16), nothing in the theory that he and the Solicitor General suggest would preclude persons in Dirks' position from trading on inside information about corporate crime. Indeed, their theory would encourage such persons so to trade.

about intentionally unreported bad news that does not rise to the level of criminal activity.[52]

Contrary to the contentions of Dirks (Br. 28-31) and the Solicitor General (Br. 28-29), the Commission's decision will not inhibit analysts' customary research or impair market efficiency.[53] Analysts remain free to obtain from corporate management corporate information that is not itself material for purposes of filling in the "interstices in analysis" and "testing the meaning of public information * * *" about corporate activities. *Investors Management Co.*, 44 S.E.C. at 646.[54] As the Commission reported to Congress in the *Institutional Investor Study, supra* p. 37, at 2539, the insider trading proscriptions do

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[52] Since willful failure to file required reports with the Commission (Section 13(a) of the Securities Exchange Act, 15 U.S.C. 78m), like any other willful violation of the Securities Exchange Act, is a crime (Section 32, 15 U.S.C. 78ff; cf. S.G. Br. 29), material facts that should have been disclosed in such reports but were not could be viewed as evidence of possible crime.

[53] See J. Lorie, *Public Policy for American Capital Markets* 3 (1974) (submitted to the Secretary of the Treasury) ("[T]he American capital markets * * * deserve high marks for efficiency both absolutely and relative to foreign markets") ["*Public Policy for American Capital Markets*"]. We do not question that the Solicitor General speaks authoritatively regarding the federal criminal law. But, Congress made the Commission responsible for ensuring that our securities markets are fair and efficient. See S. Rep. No. 792, 73d Cong., 2d Sess. 5 (1934); H.R. Rep. No. 1383, 94th Cong., 2d Sess. 7 (1934); see also H.R. Rep. No. 123, 94th Cong., 1st Sess. 92 (1975). In these circumstances, courts are not free to "disregard [an] agency's view" of one of its statutes and to construe the statute based on their "own view of what would best serve the purpose and policy" of the statute. *Federal Election Commission* v. *Democratic Senatorial Campaign Committee*, 454 U.S. 27, 36 (1981); see also *Udall* v. *Tallman*, 380 U.S. 1, 16-17 (1965).

[54] Only a "small fraction" of the information analysts acquire in their dealings with corporate insiders falls into the category of "inside information." Inside Information Comm. of the Fin. Analysts Fed'n, *New Guidelines on Inside Information*, Fin. Analysts J., Jan./Feb. 1974 at 23 ["*Guidelines on Inside Information*"]; see also *NYSE Company Manual* A-21.

not preclude "the exercise of customary institutional information gathering functions—the process by which bits and pieces of corporate information are integrated and analyzed for investment decisionmaking purposes * * *." Professional securities analysts have themselves declared use of inside information an unethical professional practice.[55]

Further, analysts do not view themselves as private investigators of criminal activities.[56] In the rare case in which an analyst does obtain material inside information evidencing criminal conduct, his professional obligation is not to remain silent but to report the information to an exchange, this agency or other law enforcement authorities.[57]

The Commission's decision to encourage analysts to report crime to the proper authorities rather than to permit trading on the undisclosed information is thus entirely reasonable. As Professor Lorie observed, while "[p]ublic policy should not generally prohibit the private exploitation of private information, * * *"

> a reasonable policy would be to require that indications of illegal actions by a corporation be disclosed to the proper authorities—typically the SEC in cases

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[55] *Code of Ethics and Standards of Professional Conduct of the Financial Analysts Federation* (as amended May 9, 1982) ["Code of Ethics"]; *Guidelines on Inside Information* at 20-25. See generally W. Chatlos, *Financial Analysts' Handbook* 74 (Levine ed. 1975); *NYSE Company Manual* A-19; C. Reich, Com. & Fin. Chron., May 17, 1973, at 13.

[56] Contrary to Dirks' suggestion (Br. 30), analysts report that they "very infrequently" obtain inside information of illegal corporate practices. Guidelines on Inside Information at 24. As Dirks previously conceded, "[i]t is rare, indeed, when an analyst uncovers a case of out-right fraud." Dirks & Gross, *supra* n.11, at 287.

[57] *See Code of Ethics, supra* note 55, Standard IIC; *The Financial Analysts Federation 1981 Membership Directory* at 23; see also W. Chatlos, *Financial Analysts' Handbook* 85; *Guidelines on Inside Information* 24; *Wall Street Analysts Agree: Raymond Dirks Blew It*, Com. & Fin. Chron., April 19, 1973 at 11.

> involving securities—before the discoverer of the information is allowed to act upon it. A reasonable interval should intervene between the notification to the authorities and the action by the informer.

Public Policy for American Capital Markets at 11.[58] The authorities can investigate discreetly, without creating the market disruption and concomitant unfairness that occurs when sensational and unproved allegations are passed from one investor to another.[59]

This Court should firmly reject the novel proposal to give tippees of insiders "a financial reward" (Dirks Br. 31) in the form of permission to trade on secret knowledge that a crime has been committed. When Congress has decided to provide rewards to persons who inform authorities about violations of federal law, it has done so expressly by statute. See, e.g., 26 U.S.C. 7623; 26 C.F.R. 301.7623-1; 33 U.S.C. 411. Even when Congress has legislated rewards, it has authorized that they be paid from fines collected from the wrongdoers themselves or from the public treasury. In contrast, here the bounty would come from the pockets of innocent investors on whom selected shareholders with inside information dumped stock. Nothing in the present securities laws suggests that Congress intended this astonishing result.

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[58] The Commission agrees that the informant is free to trade so long as at the time of the trade the information has become public or is disclosed to the buyer.

[59] Surprisingly, the Solicitor General suggests (Br. 29-30) that permitting analysts and other outsiders to trade on secret information of criminal activities would promote fairness to investors and public confidence in the securities markets. While some large investors with access to analysts' reports might benefit by his theory, other investors would inevitably be its victims. Indeed, Professor Lorie has noted that individual investors attribute lack of confidence in the market to "a feeling that individuals are at a disadvantage compared with institutional investors because the latter receive preferential treatment from brokers * * *." *Public Policy for American Capital Markets* at 5. All of Dirks' tippees in this proceeding were large institutional investors.

III. SUBSTANTIAL EVIDENCE IN THE RECORD SUPPORTS THE COMMISSION'S FINDING THAT THE INFORMATION DIRKS SELECTIVELY DISSEMINATED WAS MATERIAL

Applying the materiality standard adopted by this Court in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976), the Commission found that the information Dirks obtained from Secrist and other Equity Funding insiders would have been important to a reasonable investor (Pet. App. B14-19). The Commission found that the information Dirks obtained from Secrist on March 7 was itself material because it came from a former Equity Funding vice-president, was "specific" and "detailed," had "considerable objective indicia of reliability," and its significance to the market prices of Equity Funding securities was "immediately clear" *id. at* B14-15). Indeed, Boston made substantial sales based on this information alone (*id.*). The Commission found that by the critical March 23-26 period the information was "clearly" and "unquestionably" material (*id.* at B15).[60] By that time, the basic information about the fraud, and even arcane details, had been repeatedly corroborated by the Equity Funding insiders who Secrist had said would verify his story (*id.* at B14-15; J.A. 201, 202, 213, 234-36, 239-42, 257). The court of appeals held that these findings were supported by substantial evidence (Pet. App. C1-2), and that determination is conclusive absent extraordinary circumstances. See *Universal Camera Corp.* v. *NLRB*, 340 U.S. 474, 491 (1951); cf. *Graver Tank & Mfg. Co.* v. *Linde Air Products Co.*, 336 U.S. 271, 275 (1949).[61]

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[60] The Commission found Dirks' conduct between March 23 and March 26 alone would justify the censure (Pet. App. B26 n.54).

[61] On review "[t]he findings of the Commission as to the facts, if supported by substantial evidence, are conclusive." Section 25(a)(4) of the Securities Exchange Act, 15 U.S.C. 78y(a)(4). See *Steadman* v. *SEC*, 450 U.S. 91, 96 (1981); *Consolo* v. *Federal Maritime Commission*, 383 U.S. 607, 620 (1966).

Dirks' argument that the information at issue here was so unreliable that it was not material rests upon an attempt in this Court to relitigate for the fourth time factual contentions that were rejected by the administrative law judge (J.A. 250-74, 299-300), the Commission (Pet. App. B14-17), and the court of appeals (*id* at C1-2; *id* at A31-35).[62] Each dismissed Dirks' contention (Br. 36-37) that much of the detail of Secrist's information was "wrong" and "only three" of "the eight allegations regarding Equity Funding made by Secrist" turned out to be true (J.A. 253 n.42, 260; Pet. App. B14-15; A8, A34 & n.24). Both the administrative law judge and the court of appeals expressly stated that the "basic allegations" of insurance fraud were true, and that Dirks believed that they were probably true. (J.A. 253 n.42; Pet. App. A34 n.24; see also R. 10,772-80).[63]

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[62] There is no merit to the suggestion in Dirks' brief (Br. 35) that inside information is not material unless it has been proved to be true when the trading takes place. The possibility that an event will occur can be "a most material fact affecting the value of" a company's shares. *Strong* v. *Repide*, 213 U.S. at 432. Just as corporate officials do not await positive proof before purchasing options on property they believe to contain a remarkable ore deposit, see *Texas Gulf Sulphur*, 401 F.2d at 839-40, 843-44, 852-55, reasonable investors do not await certain proof that a company has fraudulently overstated its assets before liquidating their holdings. Moreover, in the cases relied upon by Dirks (Br. 35) the courts did not hold that information must be proved true before it becomes material. Rather, they determined, based on the particular facts before them, that the omitted information would not have been important to a reasonable investor because of the speculative or tenuous nature of the information. See, e.g., *Hassig* v. *Pearson*, 565 F.2d 644, 649 (10th Cir. 1977).

[63] Dirks arbitrarily divides the substance of his three-and-one-half hour conversation with Secrist into "eight allegations" and then claims that only three "turned out to be true" (Br. 37; see also 7-8). Secrist's report could be divided in innumerable ways. The administrative law judge divided Secrist's disclosures into

Nor was Secrist an incredible witness, as is demonstrated by the swift action of the insurance regulators upon hearing his story.[64] Likewise the Commission and the court of appeals expressly rejected Dirks' contention (Br. 35) that the information he obtained was merely "rumor" (Pet. App. B15, A35; see also J.A. 256).[65] Finally, the other insiders who corroborated Secrist's report were found to have supplied not "rumors" (Br.

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31 detailed areas (J.A. 192-94), most of which turned out to be true (J.A. 253 n.42). Moreover, Dirks provides no citation to the record for the proposition that the five purported false allegations, which are in any event insignificant, were ultimately proved incorrect. Most were in fact not proved to be false. For example, contrary to Dirks' contention (Br. 7-8), Secrist's report about insider sales was substantiated by the trustee's investigation which revealed that top Equity Funding officials had "realized huge profits" by selling Equity Funding securities prior to the disclosure of the fraud (R. 10,811, 10,814). In addition, Secrist did not, as Dirks suggests (Br. 8, 36-37), state that he was certain Equity Funding was selling limited partnerships in phony real estate; he represented this as a mere possibility, not as a fact (R. 245-47).

[64] Dirks suggests (Br. 35-38) that Secrist was not credible because Secrist was allegedly a disgruntled employee. As the administrative law judge observed (J.A. 256-57), however, a former corporate vice-president like Secrist is not likely to risk industry-wide scorn by spreading false reports of crime about his former employer. Furthermore, Dirks himself found Secrist to be credible, unbiased, straight-forward, and solid; and he believed that Secrist's information "held together well under questioning by two insurance analysts" (R. 1642, 1644).

[65] Both the Commission (Pet. App. B15 n.30) and the court of appeals (*id.* at A35) rejected Dirks' contention that the information he had was comparable to the rumors about Equity Funding that were at issue in *Pachter* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 444 F. Supp. 417, 422 (E.D.N.Y.), aff'd mem., 594 F.2d 852 (2d Cir. 1978), and *Weiner* v. *Oppenheimer & Co.*, [1979] Fed. Sec. L. Rep. (CCH) ¶ 96,764 at 95,001 (S.D.N.Y. 1979). "Rumors" are "[u]nverified information of uncertain origin." *American Heritage Dictionary of the English Language* 1135 (1969). Dirks and his tippees were well aware of their sources.

36) but rather in many cases first-hand evidence of the fraud (J.A. 234-40; Pet. App. B6-9, B17; A34).[66]

Dirks also attempts to reargue (Br. 38-42) his contention that the reactions of certain nonselling investors and regulatory officials confirm that the story was unbelievable.[67] As the administrative law judge found, Dirks never demonstrated that the non-selling investors either heard the same information as he did or stood in the posture of a reasonable investor (J.A. 267-74).[68] Nor did

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[66] Dirks misstates the record in asserting that Secrist characterized the persons who might corroborate his story as " 'wild, and erratic, and given to elaborate fantasies' " (Br. 37 n.23). Secrist's reference to "wild and erratic" persons was directed to the officers who carried out the fraud, not to the persons who were to corroborate Secrist's report (R. 711). There is also no basis in the record for Dirks' unsupported assertion (Br. 37) that Secrist told Dirks that Stanley Goldblum was not involved in the fraud. Indeed, Secrist told Dirks that Goldblum thought like a crook (R. 546) and that "most" of the top Equity Funding officers were involved (R. 481).

[67] Dirks suggests (Br. 37-38) that even by the end of his investigation all he had obtained was an "inherently unbelievable" story. But the administrative law judge found that Dirks himself believed that the disclosures were probably true (J.A. 258-60, 265; see also Pet. App. A34 & n.24) and that his contrary testimony "was less than candid" (J.A. 299-300).

[68] Dirks names (Br. 39) only four non-selling investors but suggests that "many other members of the investment community who heard some or all" of the allegations rejected them (Br. 39 and n.25 citing his brief in the court of appeals. As for the investors that Dirks mentions in his brief to this Court, two (Gene Mercy and Laurence Tisch) were found by the administrative law judge to be atypical because of their close personal relationships to Equity Funding management (J.A. 274); with respect to the other two, the administrative law judge found the evidence insufficient to find why they did not sell (J.A. 273 n.51).

Of the investors referred to in Dirks' court of appeals' brief, four of those are already mentioned. As for the others—none of whom were tipped by Dirks—the administrative law judge found that there was "lack of satisfactory proof" that they had received information of the detail and specificity as that received by Dirks' tippees (J.A. 273). One of the persons, Saul Cohen, reported what he heard to the NYSE and urged it to begin an investigation (R. 9058-61, 9234-36).

he show that the government agencies considered the allegations to be unbelievable. Accordingly, the Commission's finding of materiality, involving "delicate assessments" which are "peculiarly ones for the trier of fact," should be affirmed. *TSC* v. *Northway, Inc.*, 426 U.S. at 450.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

WHITNEY ADAMS
Assistant General Counsel

LARRY R. LAVOIE
Senior Special Counsel

RUTH E. EISENBERG
STEVEN S. THEL
Attorneys

JANUARY 1983

I authorize the filing of this brief. But see Brief for the United States as Amicus Curiae in Support of Reversal, filed December 30, 1982.

REX E. LEE
Solicitor General

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IN THE
Supreme Court of the United States

OCTOBER TERM, 1982

RAYMOND L. DIRKS,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The District Of Columbia Circuit

REPLY BRIEF FOR PETITIONER RAYMOND L. DIRKS

DAVID BONDERMAN
Counsel of Record
LAWRENCE A. SCHNEIDER
ERIC SUMMERGRAD
ARNOLD & PORTER
1200 New Hampshire Ave., N.W.
Washington, D.C. 20036
(202) 872-6700
Attorneys for Petitioner Raymond L. Dirks

March 1983

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REPLY BRIEF FOR PETITIONER RAYMOND L. DIRKS

As the Court of Appeals noted in its decision below, "[l]argely thanks to [Petitioner] Dirks, one of the most infamous frauds in recent memory was uncovered" almost exactly ten years ago. (Pet. App. A-3) In the ensuing litigation everybody from the perpetrators of the crime (J.A. 115-17) to the Commission itself (Pet. App. B-26) has acknowledged Dirks' preeminent role in the uncovering of criminal wrongdoing at Equity Funding. Moreover, throughout the litigation it has been undisputed—indeed, it could hardly be otherwise on the record—that Dirks uncovered the fraud after various regulatory agencies, most particularly the SEC, had failed to do so despite numerous opportunities. (Pet. App. A-3)

Indeed, the Solicitor General views Dirks' activities as having been of such importance in the ferreting out of criminal misconduct that he has filed an *amicus* brief urging reversal in

this case, arguing that the decisions below will have a serious negative impact on criminal law enforcement by deterring analysts who, like Dirks, would seek to investigate allegations of corporate crime. (Sol. Gen. Br. at 26-28)

Remarkably, the Commission's counsel argue for the very first time that, notwithstanding the record and the decisions below to the contrary, Dirks did nothing to uncover the Equity Funding scandal. The Commission's counsel now claim that the fraud was about to collapse of its own weight anyway (SEC Br. at 38-39 & n.46), that the regulatory agencies were hot on the tracks of the conspirators (SEC Br. at 5), and that Dirks' activities in fact delayed exposure of the fraud. (SEC Br. at 38) The Commission's counsel suggests that rather than the perpetrators of the fraud who sold worthless stock to the public being the villains, it was Dirks who "victimized" the shareholders by disseminating the allegations of fraud to the market, the auditors, and the press. (SEC Br. at 30)

These claims are completely wrong and totally unsupported by the record or the decisions below.[1]

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[1] It is simply not possible, given the limitations of space—and not useful given the general irrelevance of the SEC's factual misstatements to the legal issues at hand—to discuss in detail the serious errors, misleading statements, and omissions in the SEC's brief. To the extent these claims are not discussed in this reply, we believe that the Court will find that the statement of facts in our opening brief is fully supported by the record cites therein and, indeed, by the findings of the Administrative Law Judge, the Commission, and the court below. The SEC's recitation is not. In truth, it appears that the SEC's present counsel, none of whom participated in the original hearings, either do not know the factual record or do know it but recognize that the factual findings of the Commission and the Court of Appeals have a serious adverse impact on their arguments. *Cf. SEC* v. *McDonald*, 15 Sec. Reg. & L. Rep. 321, 322 (1st Cir. Feb. 11, 1983) ("We also note, in passing, that inconsistencies [in its arguments] do not bother the Commission.").

Commission counsel's mischaracterization of Dirks' role is part and parcel of their efforts to have this Court ignore the crucial distinctions between the exposure of serious crime that took place here and garden variety "tippee" cases. Rather than dealing with the facts of this case, the Commission single-mindedly pursues its self-appointed task, previously rejected by this Court in *Chiarella* v. *United States*, 445 U.S. 222 (1980), of assuring parity of information, to the exclusion of the important law enforcement goal of exposing serious crime. Thus, as a substitute for analysis, the Commission uses spit words like "inside information" and "tippee" (*see, e.g.*, SEC Br. at 23-25) even though the information involved here was not confidential corporate "inside" information and neither the Commission's conclusory labels, nor the theory of "tippee" liability that the Commission seeks to rely upon, are in any way applicable here. The result, unless the decision below is reversed, will be to actively discourage the disclosure of information concerning corporate fraud.

We deal with the Commission's contentions seriatim:

1. *Chiarella* Applies To This Case

The Commission does not overtly dispute that the controlling principles enunciated in *Chiarella* v. *United States*, 445 U.S. 222 (1980)—that the antifraud provisions of the laws are designed to catch fraud, and that "[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak," *id.* at 235—apply here. Instead, the Commission suggests, without quite saying so, that *Chiarella* only applies to the use of "market information." But as the Solicitor General points out in his *amicus* brief, "[a]lthough *Chiarella* dealt with nondisclosure of 'market information' . . . the Court's decision rested on general principles governing all cases of nondisclosure under Section 10(b)." (Sol. Gen. Br. at 15-16 n.7)[2]

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[2] Thus, the Commission's assertion that we and the Solicitor General "concede that there is no conflict between the Commission's

2. The SEC Has Conceded Much Of Its Case

The Commission asserts that under *Chiarella* a duty to disclose may arise under two circumstances. First, it states that the duty may arise where there has been misappropriation of information. (SEC Br. at 23-24 & n.29) But it concedes that there has been no misappropriation here. (*Id.*)

Second, it states that a duty to disclose may arise under the "traditional prohibition . . . against trading on inside information . . . which imposes liability on both insiders and their tippees." (SEC Br. at 23-24) The Commission does not contest the fact, however, that Dirks was not an insider of Equity Funding. In addition, the Commission concedes that Judge Wright's primary theory for upholding the Commission's decision—that Dirks owed a special duty of disclosure as an employee of a broker-dealer—cannot be a basis for affirmance of the decision below. (SEC Br. at 21-22 n.27)

Thus, the only remaining disputed question is whether Dirks was a "tippee" of Equity Funding insiders who inherited a duty of disclosure from them. As discussed in our opening brief and below, Dirks was not a "tippee," as that term is used under the federal securities laws, and had no duty to disclose.

3. Dirks Did Not Obtain Information Through A Breach Of An Insider's Duty And Accordingly, Under *Chiarella*, Had No Duty To Disclose

In "tippee" cases, involving the transmission of "inside" information—that is, information intended for a corporate purpose and properly maintained as confidential—to outsiders, the finding of a duty to disclose has not been difficult. The outsiders have either received the information improperly in breach of an insider's duty not to disclose, or have been proper-

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decision here and *Chiarella's* actual holding," (SEC Br. at 22), is incorrect. We and the Solicitor General have both asserted that the decisions below are in direct conflict with the rule of law established by *Chiarella*. (*See* Pet. Br. at 18-27, 31-34; Sol. Gen. Br. at 18-26)

ly entrusted with the information for a corporate purpose, but have misappropriated the information by using it for trading. (Pet. Br. at 19-23; Sol. Gen. Br. at 20-24) The fundamental difference between those cases and this one is that it does not involve "inside" information, which the law properly allows to be kept secret in order to benefit the company involved. The information which Dirks received was information about a massive corporate crime, of which the law encourages, indeed requires, the disclosure. As such, Dirks' sources were free to reveal the information. The Commission does not contest that disclosure in and of itself was legal. (SEC Br. at 25) Nor does the Commission contest the fact that Dirks, having legally acquired the information, did not then misappropriate it when he used it. (SEC Br. at 23-24 & n.29)

(a) Absent A Breach Of Duty By An Insider, An Outsider Receiving Non-Confidential Information Has No Duty To Disclose

The Commission nonetheless contends that as a result of acquiring information from Secrist, a former officer, Dirks became a "tippee" with duties to disclose. The Commission is, however, ambivalent about what it means. On the one hand, it presses the theory that was applied by the Commission in its decision, argued by the Commission's counsel in the Court of Appeals, and applied by the Court of Appeals: that the mere act of disclosure of non-public information by corporate insiders, regardless of how proper and legal, conferred on Dirks duties of disclosure. (SEC Br. at 34-35 n.41) To the extent that this is the Commission's argument, it is completely inconsistent with this Court's holding in *Chiarella* that the mere possession of non-public material information does not give rise to a duty to disclose. *See* 445 U.S. at 233.[3]

[3] The Commission has no authority for this proposition, and simply suggests that this Court in *Chiarella* did not mean to limit "tippee" liability to those circumstances where an insider breaches a duty in making disclosure. (SEC Br. at 34 n.41)

(b) Secrist Breached No Duty

On the other hand, the Commission devotes the bulk of its brief to arguing a brand new theory—that Dirks' principal source, Ronald Secrist, did breach a fiduciary duty when he made disclosure to Dirks, and that the disclosure was therefore wrongful. The Commission agrees that Secrist was under no duty to Equity Funding to keep the information about criminal fraud a secret (SEC Br. at 25), but argues that even so the disclosure constituted a breach of duty to potential shareholders of Equity Funding. (SEC Br. at 24, 30-31)

This wholly novel theory of liability is being advanced by the Commission for the first time in this Court. It was never presented to the Administrative Law Judge or the Commission, neither of whom predicated Dirks' liability on any breach of duty by Secrist. (*See* SEC Br. at 34 n.41) Indeed, the court below specifically noted that the SEC had failed to claim any such breach. (Pet. App. A-23 n.15; *see* SEC Court of Appeals Brief at 50)

The first hint of this new theory, which the SEC has adopted as virtually its sole basis for affirmance, appears in a footnote contained in Judge Wright's opinion below. He suggested that "[d]espite the SEC's failure to dispute the issue, it is not clear that California law would permit Dirks' informants to secretly provide information about Equity Funding to Dirks with reason to believe that he would profit by it." (Pet. App. A-23 n.15) Yet even Judge Wright went on to note that no applicable case had ever held such actions to be a breach of duty.[4]

This Court need not consider whether Dirks would be liable if Secrist had breached a duty. As the Commission affirmatively argues elsewhere in its brief, where a theory of liability was neither considered by the Commission nor presented to the Court of Appeals, it may not, under *SEC* v. *Chenery Corp.*, 332

[4] Judge Wright stated, moreover, that since his theory of liability did not depend on such a finding, it was unnecessary to decide if Secrist or the other sources had breached any duty. (*Id.*)

U.S. 194, 196 (1947), be relied upon to support the decision below. (SEC Br. at 21-22 n.27)

But in any case it is clear that the theory of Commission's counsel is wrong. Secrist's disclosures did not, in fact, constitute a breach of duty to potential shareholders.

Secrist, as a former insider, owed two duties to potential shareholders of the company. First, he himself could not have traded in Equity Funding stock without making full disclosure of material facts in his possession. As a former insider, he was required to disclose when dealing with the shareholders for personal profit. *See Chiarella*, *supra*, 445 U.S. at 227-28; *Strong* v. *Repide*, 213 U.S. 419, 431-35 (1909).[5] But it is undisputed that Secrist did not trade in Equity Funding stock or "knowingly confederate" with others to trade for their mutual benefit, *see Jackson* v. *Smith*, 254 U.S. 586 (1921); *Jackson* v. *Ludeling*, 88 U.S. 616 (1874). In fact, Secrist scrupulously avoided engaging in any such trades. (J.A. 15)

Secrist's second duty to the shareholders was "to administer the corporate affairs *for the common benefit of all the stockholders*, and exercise [his] . . . best care, skill, and judgment in the management of the corporation business." 3 *Fletcher Cyclopedia Corporations* § 838, at 143 (Perm. ed. 1975) (emphasis added). This duty of care is owed by corporate officers to the shareholders collectively, and "is only another way of stating that they are trustees for the corporation." *Id.* at 144. In other

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[5] This would have been true, as the Solicitor General points out, "regardless of the classification of information as inside information, market information, or evidence of crime." (Sol. Gen. Br. at 19 n.12) It is interesting to note that the Commission extensively quotes the Solicitor General on this point, but carefully deletes the words "market information" from the quote. (SEC Br. at 29) While the Commission would like to leave the impression that it is stating a theory only applicable to "inside" information, and thus distinguishable from *Chiarella*, its theory would in fact be applicable to the disclosure of any nonpublic information by an insider.

words, Secrist's duty was to consider what was in the best interests of the entire "corporate family." Consistent with that obligation, Secrist made disclosure because he reasonably believed that it was the only effective way to expose the fraud, and that exposure of the fraud was in the best interests of the corporation, its shareholders, and the public. (J.A. 15-16, 26-27)

That some shareholders lost most of their investment as a result in no way suggests that the disclosure was improper. As the Solicitor General points out, "[i]t was inevitable that the Equity Funding fraud would have victims" (Sol. Gen. Br. at 30), since regardless of what Secrist did to expose the fraud the shareholders were going to be left with worthless stock. Secrist and Dirks did not create victims. Instead, as the Solicitor General states, they prevented further victimization by the perpetrators of the fraud. (Sol. Gen. Br. at 30) Had Secrist and Dirks not acted, and had the fraud continued unabated, more phony insurance would have been created and sold off,[6] more legitimate assets would have been absorbed by the fraud, more legitimate companies would have been acquired, more embezzlement would have taken place, and more bank loans and other credit would have been fraudulently obtained.

The Commission totally fails to explain how Secrist's purpose of exposing criminal fraud could possibly conflict with any fiduciary duty. As noted, it was not in Secrist's power to determine *whether* investors would be injured. That was a *fait accompli* beyond his control. The only question was *when* the scheme would be brought to a halt. Secrist chose sooner, rather than later, and thereby advanced the welfare of the

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[6] As the Commission notes, the scheme was "Ponzi-like" in nature. Although the company made money by selling phony policies to reinsurers, these profits were soon eaten up by the premium payments they had to pay the reinsurers. Thus, more insurance policies had to be created to cover the net losses on the earlier policies. (*See* SEC Br. at 3) The longer the scheme continued, the more expansive the fraud became and the more persons who were victimized.

company, its employees, its creditors, and public investors at large. The Commission lamely suggests that Secrist either could have gone to the regulatory authorities or, if they proved as ineffective as they had been in the past, sit silently while the fraud continued. (SEC Br. at 31) The Commission is thus suggesting that it is more appropriate for a corporate fiduciary to do nothing in the face of a massive crime being committed by his corporation than to seek to expose the crime through the only means he reasonably believes will be effective (and which in fact prove to be effective). This view of fiduciary duty defies rational comprehension.

Indeed, the Commission has the audacity to suggest that if the fiduciary seeks to disclose such information, with reason to believe it will be traded on, it is analogous to contracting for a profit not to report a crime. (SEC Br. at 40) Exactly the opposite is true. It is, in fact, the Commission's proposed rule, which would punish those who seek to disclose crime, while holding blameless those who remain silent, that will persuade those with knowledge of such crimes that the appropriate and personally "profitable" course of action is to keep quiet.

In the absence of any justification for its claim that Secrist breached any recognized duty, the Commission conjures up a non-existent rule of conduct for fiduciaries, and suggests that Secrist violated that rule. The Commission argues that Secrist, in making disclosure, "authorized" whatever trading subsequently took place. It contends that just as Secrist was disabled from trading on this information, he was forbidden to "authorize" such trading.[7]

The Commission suggests a blanket rule that whatever a trustee cannot do, he cannot "authorize" others to do. There is

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[7] In fact, Secrist did not "authorize" anybody to trade, in the sense that the term is used in the Commission's cases. Secrist did expressly authorize Dirks to talk to *The Wall Street Journal*. For the rest, Secrist simply related the allegations to Dirks, and urged him to investigate and try to make them known as widely as possible, in the

no authority for such a rule and it would in fact be preposterous. Trustees commonly authorize transactions between their beneficiaries and third parties that they would be absolutely forbidden to do themselves. For example, a trustee can (and often must if a trust is to function at all) authorize the sale of trust property to third parties on fair terms, even though he himself could not buy the property, regardless of how fair the deal was. *See Restatement (Second) of Trusts* § 170, comment b (1959).

To be sure, in some circumstances a trustee's actions in "authorizing" an action by others may be improper and constitute a breach of duty. But that occurs where the trustee's action is adverse to the interests of the beneficiaries, not because he allows something he could not do himself. That was the situation, in entirely different circumstances from those presented here, in the principal cases relied on by the Commission. *See Mosser* v. *Darrow*, 341 U.S. 267, 271-72 (1951) (setting up of interest in third parties adverse to that of trust); *SEC* v. *Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971) (allowing relatives and acquaintances to trade on confidential corporate information).[8]

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apparent (and well founded) belief that the SEC would never take steps to uncover the Equity Funding fraud until market conditions forced it to act. That some persons, unknown to Secrist, to whom Dirks disclosed the allegations, chose to sell their Equity Funding stock, does not mean that Secrist "authorized" those sales.

[8] Indeed, the principal holding of these cases is a remedial rule—that *where* there has been a breach of duty, a trustee will be liable for profits realized by third parties as a result of that breach. They do not stand for the proposition that all actions by a trustee which allow a third party to profit constitute a breach of duty. It was in the context of discussing this remedial rule that the Court in *Mosser* stated that a trustee cannot authorize others to do what he cannot do. 341 U.S. at 271-72. The view is that if a trustee can breach his duty, and thereby authorize others to profit, he might be able to make a covert profit which would then be unrecoverable. *Id.* The Commission takes this statement out of the remedy discussion in which it was made, and attempts to convert it into a broad and unsupportable rule of liability.

Unlike the clear breach of duty in those cases, there is no authority that would suggest that even if Secrist "authorized" the trading that took place, that his doing so for the purpose of obtaining exposure and termination of the fraud was wrongful. Indeed, it is an established rule of trust law that a fiduciary, who does not personally profit, may make hard decisions that harm the interests of a particular class or category of beneficiaries, when that action is necessary to avert a greater harm to the beneficiaries "as a whole." *See* II A. Scott, *Scott on Trusts* § 183, at 1473 (1967). Many benefits and burdens have to be allocated among different classes of trust beneficiaries, and so long as the trustee acts reasonably in the interests of all, there is no breach of duty. That is exactly what happened here.

One final point bears reflection. If, in fact, it was Secrist who was the initial wrongdoer in this case, why did the Commission not only not charge him with any wrongdoing, but fail to even mention him in its Order for Public Proceedings? (See J.A. 1-13) The answer is obvious: the theory the Commission's counsel is pursuing was cooked up for the first time before this Court, was never considered by the Commission or its staff at any time, and is plainly wrong.

4. Neither Prior Case Law Nor The Legislative History Of The Securities Laws Supports The Decisions Below

The Commission states that prior "tippee" cases established principles prohibiting trading by corporate insiders and their "tippees," suggests that this case falls within the principles enunciated in those cases, and argues that those decisions were ratified by Congress when it adopted the Securities Acts Amendments of 1975. (SEC Br. at 35-38) In fact, the principles contained in those cases are not applicable here.[9]

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[9] In making this argument the Commission misstates both our position and that of the Solicitor General. The Commission states that we recognize the traditional rules against trading by insiders and their "tippees," but are seeking an "exception" to those rules. (SEC Br. at 21, 38) As the Commission is well aware, it is our view

The Commission cites *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), and several decisions arising out of the sale by insiders and their "tippees" of Douglas Aircraft Co. stock. *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974); *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 44 S.E.C. 933 (1971); *In re Investors Management Co.*, 44 S.E.C. 633 (1971).

As we discussed in our opening brief, all of those cases involved the misappropriation and conversion of confidential corporate information. (*See* Pet. Br. at 24 n.11, 27-28 n.16)[10] Those cases dealt with the misuse of inside information, and did not address the very different situation, presented in this case for the first time, where the information at issue is evidence of criminal fraud. Thus, the fact that Congress in 1975 left the holdings of these cases intact is not a basis for affirming the result here.[11]

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that this case does not fall within the established rules. The Solicitor General expressly stated in his brief that "the disagreement between the United States and the Commission herein relates only to the *extension* of well-established legal principles to the facts of this unusual case." (Sol. Gen. Br. at 19 n.11) (emphasis in original).

[10] The Commission argues that the information in these cases could not have been corporate information capable of being misappropriated because 1) it was negative earnings information and 2) it was publicly released shortly after it was used by the insiders. (SEC Br. at 36) But the fact that the information was unfavorable did not mean that it had no corporate purpose and was not of value to the corporation. And the fact that it was publicly disclosed shortly after it was privately used did not mean that the private use, other than in accordance with the corporate disclosure schedule, was any less misappropriation. As was pointed out both in our brief and by the Solicitor General, all true "inside" information will be disclosed by the company. (Pet. Br. at 28-29; Sol. Gen. Br. at 28-29 n.24) The misappropriation lies in acting before disclosure.

[11] The Commission notes that the Congress intended to insure that "dealing in securities is fair and without undue preferences or advantages among investors." (SEC Br. at 37, *quoting* H.R. Rep. No. 229,

5. Public Policy Requires Allowing The Independent Investigation Of Criminal Fraud

The Commission claims that there are several reasons why activities such as Dirks' should be considered contrary to public policy. These arguments are without foundation, and totally fail to rebut the view of the Department of Justice—the federal agency responsible for criminal law enforcement—that penalizing the activities of analysts like Dirks will have a serious negative impact on criminal law enforcement.

(a) The Independent Investigation of Corporate Fraud Will Promote Public Disclosure Of Such Crimes

The Commission's principal policy argument is that if securities analysts are allowed to investigate independently allegations of corporate criminality, they will be less likely to make "prompt disclosure of crime to public officials." (SEC Br. at 40)

In fact, the delay between the start of Dirks' investigation and his going to the Commission staff was two weeks, during which time he repeatedly sought to have Equity Funding's auditors and *The Wall Street Journal* investigate and disclose the allegations. Even crediting this delay as of any importance (in a case the Commission staff had sat on for over a year), this

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94th Cong., 1st Sess. 91 (1975)) The key word here is "undue." Under *Chiarella* an outsider who legally obtains non-confidential information may thereby obtain an informational advantage, but not an "undue" advantage. *See* 445 U.S. at 232. Indeed, even Justices Blackmun and Marshall, dissenting in *Chiarella*, stated after reviewing the case law in this area that an undue advantage only arises where an individual has access to information that is legally unavailable to others. *See* 445 U.S. at 249-51. As we pointed out in our opening brief (Pet. Br. at 27 n.15), and as the Solicitor General points out in his (Sol. Gen. Br. at 24-26), the information Dirks obtained was legally available to other investors willing to make the effort Dirks did. The Commission, in its brief, does not contest this. Even under the dissenters' view in *Chiarella*, undue advantages arise only when one has an opportunity "for profit from manipulation of confidential connections or resort to stealth." 445 U.S. at 252 n.2. Dirks' informational advantages arose from neither. They arose from "honest means," and were entitled to "reap their full reward." *Id.*

argument ignores the fact that if securities analysts who hear allegations of fraud are not permitted to investigate allegations of fraud, and obtain some benefit by doing so, they will not, as an alternative, spend their time ferretting out allegations to report to the regulators. Instead, they will do what the Commission's counsel has suggested was Dirks' other alternative—"nothing." (Transcript of Proceedings before Securities and Exchange Commission of June 13, 1979, at 35)

More importantly, the Commission glosses over the fact that the end result to be sought is not disclosure to "public officials," but action by those public officials to verify the crimes and make disclosure to the public. After all, these same "public officials" had been told of the fraud on three separate occasions over a period of years and managed to avoid uncovering any aspect of the scheme. Thus, Dirks' investigation sped the public exposure of a fraud that, in Judge Wright's words, "[t]he SEC had a history of failing to act promptly in." (Pet. App. A-9 n.6)[12] The actions of securities analysts can, as the Solicitor General and the Assistant Attorney General in charge of the Criminal Division observe, serve as a useful adjunct to the efforts of public officials in disclosing crime. (Sol. Gen. Br. at 27-28)

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[12] In defense of its own record, the Commission states that the first its staff heard of the fraud was in March 1973, and that the statements that it heard the allegations in 1971 rests on a "misunderstanding." There is no misunderstanding. The record is clear that in late 1971 the Controller of Equity Funding, William Mercado, related details about the fraud, including details about phony insurance and phony confirmations of that insurance, to Morton Field, a private attorney and former SEC staff member. (J.A. 106) Field immediately contacted Rudy Reinchild, an SEC staff member at the Commission's Los Angeles office who was a "good friend" of his. (J.A. 101) He related the details of Mercado's story, including details about phony insurance and confirmations, to Reinchild. (J.A. 106-07) He subsequently related the same details to Marty Robins, another staff member at the Los Angeles office. (*Id.*) In spite of this, when Mercado was interviewed by the staff members shortly thereafter he was never questioned by them about the phony insurance allegations.

The present case is a perfect example. The record is clear that even as Dirks was making his investigation the various state regulatory agencies which were looking into the matter (as noted, the SEC once again had declined to investigate) found no evidence of fraud. (R. 7212; Dirks Ex. R, J.A. 163, 167, R. 7649, 7650) Not surprisingly, the conspirators had undertaken to conceal their wrongdoing. (Division Ex. 1, pp. 107-10, R. 159, 3877) There is nothing to suggest that, in the absence of Dirks' investigation, these efforts at concealment would not have been as successful as they had been in previous years.

The Commission would like to suggest that the fraud would have collapsed anyway. They quote in part the reorganization Trustee of Equity Funding, who concluded that the fraud avoided detection "mainly because of audacity and luck," (SEC Br. at 38 n 46), and suggest that once the regulators were aware of the allegations they necessarily would have quickly uncovered the truth. (SEC Br. at 5) What the Commission does not quote is the Trustee's conclusion that the conspirators' "luck" in concealing the fraud ran out "because of accelerating events outside the Company. Between March 19 and March 27, rumors on Wall Street of fraud at Equity Funding began to significantly affect trading in the company's stock. These rumors were based on information Secrist had given to Raymond Dirks, an insurance analyst with the New York brokerage firm of Delafield Childs, Inc." (Division Ex. 1, p. 110, R. 159, 3877).

As the trustee stated, what broke the scheme was a chain of events directly resulting from Dirks' activities. As Dirks disseminated the allegations, and as rumors of fraud spread

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(J.A. 111-12) Although Mercado, believing he was in legal danger, did not volunteer any information (J.A. 114), it was surely the obligation of the staff members, having heard the allegations from a highly reliable source, to ask. Furthermore, as Mercado testified in these proceedings, Mercado later agreed to make a full disclosure if the SEC would arrange for a grant of immunity. (J.A. 112-14) The SEC staff refused to be bothered, telling Mercado's lawyer that the case was closed. (J.A. 113-14)

throughout the market, there was a dramatic fall in the price of Equity Funding's stock, amid substantial trading. (J.A. 4)

This substantial trading in, and dramatic drop in the price of, Equity Funding stock forced the New York Stock Exchange (and, tagging along after the Exchange acted, the Commission) to suspend trading in the stock, even though they had no evidence that the rumors were true. (I.D. 134-35, J.A. 269-70) The Commission's staff was also forced to give the case priority, and take decisive action to either confirm or refute the rumors.[18] In contrast to their half-hearted investigation in 1971 or their casual dismissal of the story in early March 1973 (J.A. 96-98), and even though the Commission's chief enforcement officer still thought that the allegations were not firm enough to require action (Boston Co. III Ex. JJJ, p. 90, R. 8264, 8390), the Commission's staff called in the top officers of Equity Funding for questioning and requested that they "immediately furnish affidavits denying all rumors of fraud." (Dirks Ex. R, J.A. 163, 165, R. 7649, 7650)

This was the pivotal event. In response, the top conspirators retained criminal lawyers and decided to plead the fifth amendment. (R. 8112-16) Their refusal to testify was the first indication that the allegations were true. Based on that, and on the report from Illinois of missing assets, but nothing else, the California Insurance Department seized Equity Funding. (R. 7205-06) The Secretary and General Counsel of Equity Funding, who had until then believed the stories to be "vicious

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[18] In addition, in response to the rumors, the honest officials of Equity Funding, led by Rodney Loeb, the company's General Counsel and Secretary, forced an internal investigation, believing that the rumors would readily be proven false. (R. 8077-82) This substantially impaired the conspirators' ability to proceed with any cover-up. For example, the first evidence of any fraud was the discovery by the Illinois Insurance Department that substantial assets of the company, supposedly in a Chicago bank, were missing. (I.D. 137, J.A. 271) The conspirators had devised a complex, but workable, plan for explaining this away (*see* Division Ex. 1, pp. 108-09, R. 159, 3877), but apparently were unable to implement it under the circumstances created by Dirks' activities.

rumors" (R. 8101-02), immediately called a special meeting of the Equity Funding Board for two days later. (R. 8121-22) At that meeting Goldblum and the other conspirators were dismissed from the company. The remaining board members agreed to the appointment of an interim manager and new auditors, and fully cooperated with the SEC in its subsequent investigation. (Division Ex. 1, p. 119, R. 159, 3877)

It is for this reason that Judge Wright concluded that "[l]argely thanks to Dirks, one of the most infamous frauds in recent memory was uncovered and exposed." (Pet. App. A-3) Indeed, even the Commission conceded that "[i]t is clear that Dirks played an important role in bringing EFCA's massive fraud to light." (Pet. App. B-26) But under the rule of law proposed by the SEC there will be no more investigations like Dirks undertook here.

(b) Allowing Investigation Of Corporate Crime Is Not Unworkable

The Commission's second policy argument is that allowing securities analysts to investigate and disclose allegations of corporate crime would impose an unworkable standard of behavior on analysts since some conduct might not clearly be criminal.[14] (SEC Br. at 42)

In fact, the standard is nothing more than a subtest of the test set forth in *Investors Management*—that a recipient of information "know or have reason to know that it was nonpublic and had been obtained *improperly* by selective revelation or otherwise." 44 S.E.C. at 641 (emphasis added). Under that standard, the recipient of information must always evaluate whether he has improperly received information or whether he was entitled to receive it.

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[14] The Commission suggests, along these lines, that to allow trading on information about criminal activity would also allow trading on "information about intentionally unreported bad news that does not rise to the level of criminal activity." (SEC Br. at 42) The answer to this contention is that if a corporation is willfully failing to disclose bad news, in violation of the disclosure provisions of the securities laws, insiders are released from their obligation not to disclose such

(c) Allowing The Independent Investigation Of Corporate Crime Will Promote Market Efficiency And Confidence

The Commission's final policy contention is that allowing trading on information about criminal activity will neither improve market efficiency nor promote investor confidence. The argument as to market efficiency is in essence that the market already is highly efficient. The Commission cites a statement made in 1974 by Professor James Lorie of the University of Chicago. While Professor Lorie has indeed praised the existing efficiency of the securities markets, he has since also stated, in discussing this case, that "[t]he main improvements in the system of disclosure" will come from the private initiative of analysts like Dirks. Lorie, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy: a Comment*, 9 J. Leg. Stud. 819, 822 (1980). As we have noted in our principal brief, Professor Lorie is of the view that Dirks' activities deserve high praise, not punishment. *Id.* Moreover, the SEC insists that analysts rarely obtain information about corporate fraud, so that the revelation of such crimes would be minimal and would not greatly affect overall market efficiency. Even if that were so, it hardly supports a policy of discouraging persons from uncovering whatever fraud does exist.

Furthermore, confidence in the securities markets will be substantially enhanced if the investing public knows that there are even a few securities analysts seeking to ferret out corporate fraud, operating as a check on those analysts who principally rely on information disseminated by the company, and also serving as a deterrent to those who would consider perpetrating such fraud.[15]

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information. Indeed, dissemination of the information to the market may be the only way to make effective disclosure. The mandatory disclosure obligations of the securities laws would have little meaning if corporate officials could be forced to keep information required to be disclosed a secret or be charged with a breach of fiduciary duty.

[15] The Commission contends, again quoting Professor Lorie's 1974 statement, that investor confidence would be diminished since the investigation and disclosure of crime by securities analysts would

6. The Allegations Heard By Dirks Were Not "Facts" Subject To Disclosure Obligations Under The Federal Securities Laws

The Commission fails to deal with the fact that the stories heard by Dirks were not "facts" subject to disclosure obligations under the antifraud provisions of the federal securities laws, but rather were unverified allegations.[16] The clearest evidence of this, which the Commission does not contest, is that even after hearing everything which Dirks had to say, neither the SEC nor the New York Stock Exchange believed that they had anything but unverified allegations, on which they could not act, and *The Wall Street Journal* did not believe that they could publish a story based on the allegations. (Pet. Br. at 41-42). In fact, the head of the SEC's Enforcement Division testified to this effect before Congress. (Boston Co. III Ex. JJJ, p. 90, R. 8264, 8390) In spite of the fact that these responsible regulators, and a responsible newspaper, did not believe that the information was something they could act on,

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favor large institutional investors, who generally have better access to such analysts than small investors. (SEC Br. at 44 n.59) Of course, many of these institutional investors, such as pension funds and mutual funds, are really amalgamations of small investors. Furthermore, to the extent the individual small investor is disadvantaged, this is, as Professor Lorie notes, an existing structural problem, and would be the same with respect to any legally derived information gathered by an analyst. That it would be true with respect to this information as well does not render the use of this information by analysts any more "unfair" than their everyday activities already are.

[16] The Commission concentrates entirely on the question of whether these allegations were considered important by some investors, and thus were in some sense "material." This is a totally separate issue. Even a bare rumor, if shocking enough, may be considered important by a reasonable investor even if there is only a small chance that it is true. But such rumors have never been considered to be "facts" which must be disclosed in the course of trading. *See, e.g., SEC* v. *Monarch Fund*, 608 F.2d 938 (2d Cir. 1979); *Hassig* v. *Pearson*, 565 F.2d 644 (10th Cir. 1977); *Ruszkowski* v. *Hugh Johnson & Co., Inc.*, 302 F. Supp. 1371 (W.D.N.Y. 1969).

the Commission contends that the stories were "reliable" enough for Dirks to be required to disclose them.

As we have discussed in our opening brief, treating such unverified (and possibly false) allegations as "fact" will force analysts who hear such rumors to "act at their peril," *SEC* v. *Monarch Fund*, 608 F.2d 938, 943 (2d Cir. 1979), since they will not be in a position to obtain public disclosure of the stories[17] and cannot be sure that the stories will ever be confirmed or refuted. The only appropriate way to treat such rumors is to allow the analyst to investigate them, seek out information about them from others in the investment community, and attempt to either confirm them or refute them. That is what Dirks did, and it is an eminently proper course of conduct.

CONCLUSION

For the foregoing reasons, and for the reasons stated in our opening brief and that of the Solicitor General of the United States, the decision of the Court of Appeals should be reversed.

Respectfully submitted,

DAVID BONDERMAN
Counsel of Record
LAWRENCE A. SCHNEIDER
ERIC SUMMERGRAD

ARNOLD & PORTER
1200 New Hampshire Ave., N.W.
Washington, D.C. 20036
(202) 872-6700
Attorneys for Petitioner
Raymond L. Dirks

March 1983

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[17] As we observed in our opening brief, Dirks in fact did everything that was in his power to obtain public disclosure of the fraud. (*See* Pet. Br. at 17)

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No. 82-276

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1982

RAYMOND L. DIRKS,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF OF SECURITIES INDUSTRY ASSOCIATION, *AMICUS CURIAE* IN SUPPORT OF NEITHER PARTY

EDWARD H. FLEISCHMAN
RICHARD E. NATHAN
MARTIN P. UNGER
GASTON SNOW BEEKMAN & BOGUE
14 Wall Street
New York, New York 10005
(212) 227-8200
Attorneys for Securities Industry Association

WILLIAM J. FITZPATRICK
General Counsel
RONALD T. CARMAN
Assistant General Counsel
SECURITIES INDUSTRY ASSOCIATION
120 Broadway
New York, New York 10271

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IN THE

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BRIEF OF SECURITIES INDUSTRY ASSOCIATION, *AMICUS CURIAE*

Pursuant to Rule 36.2 of this Court, and with the consent of the parties, the Securities Industry Association submits this brief as *amicus curiae*. It supports neither party.*

QUESTION ADDRESSED

Whether the Honorable J. Skelly Wright erred in concluding that the federal securities laws taken as a whole impose upon broker-dealers, by virtue of their status as such, a broad legal disclosure obligation in favor of the public at large and a correlative duty to report to the Commission supposed federal securities law violations committed by others.

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* Since the Securities Industry Association supports neither party, this brief is being submitted to the Court within the time prescribed for the petitioner, as required by Rule 36.2.

THE INTEREST OF THE SECURITIES INDUSTRY ASSOCIATION

The Securities Industry Association (the "Association") is a trade association comprised of approximately 500 brokers and dealers in securities who transact business throughout the United States and the free world. Its membership is responsible for over 90 percent of the securities brokerage business conducted in this country and includes members of every national securities exchange as well as securities firms that are not members of any exchanges.

The Association's members service securities investors of every size and type and perform a complete spectrum of professional securities activities, including retail and institutional brokerage, over-the-counter market making, underwriting and other investment banking activities, various exchange floor functions, and money management and investment advisory services. As a consequence, the Association is generally recognized as a spokesman for the securities industry in general and the broker-dealer community in particular.

The Association recognizes that high standards of ethical behavior are required of brokers and dealers in securities. In the court below, however, the Honorable J. Skelly Wright, Circuit Judge, in a published opinion expressing his views alone, has presented these ethical responsibilities as the basis of a vague but expansive "duty" of brokers and dealers to the public and to the Securities and Exchange Commission, a violation of which Judge Wright found to contravene the antifraud provisions of the federal securities laws.

This formulation—converting standards of business ethics into a predicate for civil and presumably criminal responsibility—has no basis in law or in sound public policy. If accepted and followed, however, it could work substantial mischief, calling into question the lawfulness of a wide variety of necessary functions performed by brokers and dealers and their employees. For these reasons, the Association submits this memorandum, *amicus curiae*. It urges this Court expressly to reject Judge Wright's concept of a general duty and the erroneous theory upon which it is based. It takes no position concerning any other matter in issue.

STATEMENT OF THE CASE

1. Petitioner, Raymond L. Dirks, was an officer of a registered broker-dealer. He specialized in providing investment advice about the insurance industry, primarily to institutional investors. Mr. Dirks was not directly compensated for his advisory services, but benefited when those whom he advised directed their brokerage business to the firm by which he was employed.

In March 1973, Mr. Dirks received information from a former employee of Equity Funding Corporation of America, the securities of which were traded on the New York Stock Exchange, to the effect that the assets of that Company were vastly overstated as the result of fraudulent internal corporate practices. As a result, Mr. Dirks examined and analyzed publicly available data, sought confirmation of what he had been told from others in the investment community and solicited information from then present and past officers and other employees of the Company.

While Mr. Dirks was investigating the matter, he had been in contact with a number of investors and analysts with whom he had candidly discussed the progress of his investigation and the information he had obtained. Some of those to whom he spoke sold their Equity Funding securities.

2. On the basis of these facts, the Securities and Exchange Commission censured Mr. Dirks. *In re Dirks*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶82,812 (hereinafter the "SEC Opinion"). It found that he had aided and abetted several investment managers in violating the antifraud provisions of Section 17(a) of the Securities Act of 1933, 15 U.S.C. §77q(a), and Rule 10b-5, 17 CFR §240.10b-5, promulgated by the Commission pursuant to Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C §78j(b). The Commission found that the investment managers had sold Equity Funding securities on the basis of material, non-public, "inside" information that Mr. Dirks had supplied. The Commission held, SEC Opinion, *supra*, at 83,945:

> "The dissemination of inside information to those who utilize it in dealing with uninformed public investors

constitutes an act, practice, or course of conduct which operates as a fraud on investors. Even where the tipper does not himself engage in trading, he aids and abets the violation by providing the means by which the wrongful act occurs."

The Commission expressly recognized the important function served by securities analysts who "seek out bits and pieces of corporate information not generally known to the market for the express purpose of analyzing that information and informing their clients." It observed that "market efficiency in pricing is significantly enhanced by such initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors." It concluded, however, that "professionals have no special license to ignore the insider trading proscriptions of the federal securities laws." Thus, "regardless of their motivation or occupation," persons who "come into possession of material 'corporate information that they know is confidential and know or should know came from a corporate insider,' . . . must either publicly disclose that information or refrain from trading." SEC Opinion, *supra*, at 83,945 (footnotes omitted).

3. Upon petition for review, the United States Court of Appeals for the District of Columbia Circuit affirmed the Commission's decision without opinion, *Dirks* v. *SEC*, 675 F.2d 1339 (D.C. Cir. 1982). In a judgment entered March 29, 1982, the Court stated, Judge Tamm dissenting, that "[t]he record in this case fully supports the Commission's finding that petitioner breached his duty to the Commission and to the public not to misuse insider information . . . ," *see Dirks* v. *SEC*, 681 F.2d at 824, n. (D.C. Cir. 1982).

4. The matter was not, however, left in that posture —focused sharply upon the misuse of insider information. Instead, in a widely publicized opinion, 681 F.2d 824, the Honorable J. Skelly Wright, Circuit Judge, expressed his views concerning what he perceived to be a far broader responsibility to the public and to the Commission arising solely out of Mr. Dirks' employment by a broker-dealer, *id.* at 840-842.

Judge Wright, *id.* at 835-837, acknowledged the importance to this case of this Court's opinion in *Chiarella* v. *United States*, 445 U.S. 222 (1980). There, this Court recognized that a failure to disclose material information in connection with the purchase or sale of securities might operate as a fraud or deceit under Rule 10b-5—but only where there exists an identifiable duty to disclose.

This Court also explicitly rejected the existence of any "general duty between all participants in market transactions to forgo actions based on material, nonpublic information." It observed that "[f]ormulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties, . . . should not be undertaken absent some explicit evidence of congressional intent." And it noted that "no such evidence emerges from the language or legislative history of §10(b)." *Id.* at 233.

Nevertheless, Judge Wright concluded that Mr. Dirks "had obligations to the SEC and to the public completely independent of any obligations" arising out of the misuse of material inside information obtained from sources at Equity Funding. These broader obligations were said to be "implicit in the scheme of broker-dealer registration under the Federal Securities laws," and to give rise to a "duty to disclose-or-refrain" even in circumstances in which no similar duty would be imposed upon the insiders at Equity Funding from whom Mr. Dirks obtained the information. 681 F.2d at 840. Indeed, according to Judge Wright, "a duty to report what he had learned to the SEC and not to foster such sales" is a "fundamental obligation [that] would inhere in the securities laws enacted by Congress even if they included no generally applicable antifraud provisions," *id.* at 841-842.

Thus, without regard to whether inside information was involved, whether information was obtained by misappropriation, conversion or other unlawful means, or whether

other market participants might similarly have gained access to relevant information, and without regard to Congressional inclusion of generally applicable antifraud provisions in the federal securities laws, Judge Wright concluded that broker-dealers, and those who obtain information from them, are forbidden to trade in securities without first disclosing any material, non-public information they possess.

SUMMARY OF ARGUMENT

Unless the principle formulated by Judge Wright is emphatically rejected by this Court and the uncertainty engendered by his opinion is thus laid to rest, the adverse effects upon this nation's capital markets could well be substantial. Brokers will be severely inhibited in their advisory and investment banking activities and dealers will be placed in needless jeopardy when they perform specialist, block positioning, floor trading and other functions essential to the efficient operations of the securities markets. Judge Wright apparently did not consider these consequences.

To impose upon broker-dealers a broad duty to disclose all material, non-public, non-inside information they obtain in the normal course of their business or to refrain from trading (or recommending trades) in affected securities would abrogate the detailed and sophisticated legislative scheme enacted by Congress, and implemented through rules adopted by the Commission, expressly to deal with broker-dealer responsibilities. Similarly, to charge broker-dealers with the duty to police the securities law violations of others and to "report [such violations] ... to the SEC" would assign obligations to broker-dealers that are instead vested by express statutory provisions in the self-regulatory organizations and in the Commission itself.

ARGUMENT

THERE IS NO BASIS IN LAW OR IN SOUND PUBLIC POLICY FOR IMPOSING UPON BROKER-DEALERS THE BROAD DUTIES FORMULATED BY JUDGE WRIGHT

A. *Judge Wright's formulation does substantial violence to the statutory scheme he claims to vindicate.*

Judge Wright's conclusion that there are "obligations, implicit in the scheme of broker-dealer registration under the federal securities laws, [which] provide a basis for imposing a duty to disclose-or-refrain on Dirks even if we would not impose it on his sources at Equity Funding," 681 F.2d at 840, contravenes the careful pattern of detailed regulation of broker-dealers embodied in the federal securities laws and finds no support in the decided cases.

Judge Wright correctly recognizes that "the main focus of the SEC's regulation of broker-dealers has been to ensure that broker-dealers treat their customers honestly and fairly." He asserts, however, that "fairness to their customers is not the only obligation that the securities laws impose on broker-dealers," and observes that brokers and dealers are subject to "myriad duties not imposed on corporate officers or other members of the general public," 681 F.2d at 840.[1]

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[1] The duties imposed upon issuers and their insiders, while different from those imposed upon brokers and dealers, are no less significant. In addition to the substantial responsibilities and potential liabilities that arise in connection with public offerings and otherwise under the Securities Act, the Securities Exchange Act imposes registration and disclosure obligations upon issuers of exchange-traded and over-the-counter securities, periodic reporting requirements, and broad disclosure obligations with respect to proxy solicitations.

In order specifically to inhibit misuse of material corporate information by insiders, it also requires that officers, directors and substantial shareholders of a company report their securities transactions and that short-term profits arising out of such transactions shall inure to and be recoverable by the company. No comparable obligation is imposed upon brokers and dealers.

In view of the primary disclosure requirements imposed upon issuers and their insiders, it seems anomalous for Judge Wright to have required disclosure from outside professionals while stating, 681 F.2d at 840, that he might not subject the corporate insiders (from whom the information was obtained) to the same duty.

This is surely true. Numerous provisions of the Securities Exchange Act of 1934, both as originally adopted and as amended several times since, establish a system for the comprehensive regulation of the securities markets and the activities of brokers and dealers.[2] But, contrary to what Judge Wright has assumed, the "myriad duties" that the Act expressly imposes are themselves the clearest evidence that Congress did not choose to define the disclosure obligations of broker-dealers without regard to the special functions they perform, or to impose upon them a standard so vague and uncertain of application that its very existence would remain undiscovered for nearly 50 years.

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[2] *E.g.*, Securities Exchange Act §5, 15 U.S.C. §78e (prohibiting broker-dealers from effecting transactions on unregistered exchanges); §§6(c)-(f), 15 U.S.C. §§78f(c)-(f) (prescribing conditions and limitations of broker-dealer membership on exchanges, discipline of such members, commissions chargeable, and compliance by non-members with exchange rules); §7(c), 15 U.S.C. §78g(c) (regulating extension of credit by broker-dealers); §8, 15 U.S.C. §78h (restricting borrowing and lending by broker-dealers); §§9-10, 15 U.S.C. §§78i-j (prohibiting manipulation of security prices and other manipulative and deceptive acts); §11, 15 U.S.C. §78k (restricting trading by broker-dealers); §11A(c), 15 U.S.C. §78k-1(c) (regulating broker-dealers' transactions in certain securities); §12(a), 15 U.S.C. §78*l*(a) (prohibiting broker-dealers from effecting transactions in unregistered non-exempt securities); §14, 15 U.S.C. §78n (regulating broker-dealers' activities in connection with proxy solicitations and tender offers); §15(a)-(d), 15 U.S.C. §78*o* (a)-(d) (requiring registration of broker-dealers and prohibiting broker-dealers from manipulative and deceptive acts in off-exchange transactions); §16(d), 15 U.S.C. §78p(d) (exempting certain market making activities from profit recapture); §17, 15 U.S.C. §78q (prescribing recordkeeping and reporting requirements for broker-dealers); §17A(e), 15 U.S.C. §78q-1(e) (relating to movement of securities certificates among broker-dealers); §18, 15 U.S.C. §78r (prescribing liability for misleading statements in reports filed under the Act); and §§19(d)-(g), 15 U.S.C. §§78s(d)-(g) (relating to disciplinary proceedings by self-regulatory organizations and their enforcement of broker-dealers' compliance with the Act); implemented by the rules promulgated by the Commission thereunder. Provisions of the Securities Act of 1933, 15 U.S.C. §77a, *et seq.*; the Investment Advisers Act of 1940, 15 U.S.C. §80b-1, *et seq.*; and the Investment Company Act of 1940, §80a-1, *et seq.*; also regulate the activities of broker-dealers acting in various capacities.

Thus, in *Chiarella* v. *United States*, 445 U.S. 222, 233 n.16 (1980), with specific reference to the role of broker-dealers in the securities markets, this Court recognized that

> "the problems caused by misuse of market information have been addressed by detailed and sophisticated regulation that recognizes when use of market information may not harm operation of the securities markets."

It found that the "detailed and sophisticated regulation" prescribed by Congress to deal with "the problems caused by misuse of market information" provided a strong reason to *reject* the existence of any general duty to the marketplace, and that "Congress's careful action" in this respect "contrasts, and is in some tension, with the broad rule of liability . . ." (which this Court characterized as "a new and different theory of liability") that it had been asked to adopt, 445 U.S. at 233-234.

Furthermore, this Court emphasized that

> "the 1934 Act cannot be read '"more broadly than its language and the statutory scheme reasonably permit."' . . . Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under §10(b) does not arise from the mere possession of nonpublic market information. The contrary result is without support in the legislative history of §10(b) . . . ."

445 U.S. at 234-235 (citations omitted).[3] Justice Powell, on behalf of the majority, recognized that §10(b) imposes a duty

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[3] In *Chiarella*, as the foregoing quotations evidence, this Court addressed a case of non-disclosure of so-called market information, but the premises of that decision addressed problems of non-disclosure generally:

> "[A]dministrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under §10(b) despite the absence of statutory language or legislative history specifically addressing the legality of non-disclosure."

445 U.S. at 230.

to speak arising "from a relationship of trust and confidence between parties to a transaction," *id.* Active participation by an employee in transactions operating as a fraud on a broker-dealer's customer has been held to be a breach of a duty arising from a relationship of trust and confidence.[4] Other members of this Court expressed their views that a duty to speak might arise out of use of information improperly obtained, wrongfully converted or otherwise derived by unlawful means. Utilization for an employee's own benefit of information obtained from a broker-dealer's investment banking client has been held to be a breach of a duty arising out of deceitful misappropriation.[5]

Additional, similar duties on the part of broker-dealers, in favor of customers and co-professionals (among others), arise under several of the provisions cited in footnote 2, *supra*. But, in contrast to the duty Judge Wright gleans from the "scheme of federal securities regulation, taken as a whole," 681 F.2d at 840, a breach of those duties is in each case a violation of a particular statutory provision or of a particular rule adopted by the Commission, and in each case those duties run in favor of identifiable persons or discrete groups—not in favor of the public at large.

Section 10(b) was not enacted to allow the Commission by regulation to abrogate the specific provisions of the Act. Rather, it was intended (as if to avoid the need for construing obligations out of the general statutory scheme) to allow the Commission to fill in the statutory interstices by providing, in effect, "Thou shalt not devise any other cunning devices."[6] Judge Wright's interpretation would override both the pervasive detailed structure of broker-dealer regulation and the broad interstitial thrust of §10(b).[7]

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[4] *Rolf* v. *Blyth, Eastman Dillon & Co.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,525, *amending opinion reported at* 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978).

[5] *United States* v. *Newman*, 664 F.2d 12 (2d Cir. 1981).

[6] Stock Exchange Regulation: Hearings before House Comm. on Int. and For. Commerce, 73d Cong., 2d Sess. 115 (1934).

[7] Nor do the provisions of the Securities Act provide any support for Judge Wright's conclusions. That Act was adopted to regulate "flotation" of securities through a requirement of registration of securities and the imposition of liability for improper disclosure in the registration statement upon the issuer and its directors, accountants, engineers, appraisers and underwriters, among others. "This throws upon *originators* of securities a duty of competence as well as

In support of the duty he has articulated, Judge Wright relies primarily upon broad generalizations concerning "the importance of broker-dealers within the securities markets," *id.* at 840, the obligation of broker-dealers "to meet a high standard of ethical behavior in their activities," *id.*, and the Congressional objective "to achieve a high standard of business ethics . . . in every facet of the securities industry," *id.*, citing *United States* v. *Naftalin*, 441 U.S. 768, 775 (1979) (emphasis omitted). Thus, in substance, he invokes the "remedial purposes" of the securities laws. *But see Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 578 (1979); *SEC* v. *Sloan*, 436 U.S. 103, 115-116 (1978).

Judge Wright is correct, of course, that the draftsmen of the federal securities laws were sensitive to the ethical responsibilities of brokers and dealers. But it does not follow, as he suggests, that they wrote those ethical responsibilities into positive law.

To the contrary, Congress has left the responsibility for the development and enforcement of ethical standards with the securities industry itself. The Securities Exchange Act draws a deliberate distinction between express legal obligations of brokers and dealers, which are primarily the responsibility of

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innocence which the history of recent spectacular failures overwhelmingly justifies." H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933) (emphasis added). Broker-dealers acting as underwriters have been held by the Commission to assume a broad duty in connection with origination of securities of certain issuers previously unknown to the public securities markets; broker-dealers acting as distributing dealers or dealers active in the market during a prescribed period after commencement of a distribution are subject to prospectus delivery requirements and standards of accuracy and completeness in the affirmative disclosures they make to purchasers.

But, except to the extent that a broker-dealer may have a role in the public offering of specific securities, and then only while that role continues, the Securities Act imposes no greater disclosure obligation upon a broker-dealer than upon any other market participant. Thus the Act specifically exempts, from registration and disclosure document delivery requirements, "the execution by brokers of customer orders in open market," H.R. Rep. No. 85, *supra*, at 6. It further recognizes "that a dealer is often concerned not only with the distribution of securities but also with trading in securities," *id.* at 16. Consequently, it also exempts "transactions by a dealer in securities not connected by time or circumstance with distribution of a new offering," *id.* at 6. *See* Securities Act §§4(3) and 4(4), 15 U.S.C. §§77d(3) and d(4).

the Commission to enforce,[8] and their ethical responsibilities, which are the province of the self-regulatory organizations.[9]

Thus, this Court has repeatedly noted that

> "[t]wo types of regulation are reflected in the [Securities Exchange] Act. Some provisions impose direct requirements and prohibitions. Among these are mandatory exchange registration, restrictions on broker and dealer borrowing, and the prohibition of manipulative or deceptive practices. Other provisions are flexible and rely on the technique of self-regulation to achieve their objectives."[10]

Accordingly, as the relevant committees of both houses of Congress have recognized, under the Securities Exchange Act

> "[t]he SEC has the authority and responsibility to assure compliance by all broker-dealers with the *legal* requirements of the Exchange Act and of the rules which the SEC is authorized to promulgate under the Exchange Act,"

while, at the same time,

> "[i]ndustry organizations, *i.e.*, the exchanges and the NASD, are delegated governmental power in order to enforce, at their own initiative, compliance by members of the industry with *both legal requirements* laid down in the Exchange Act *and ethical standards going beyond those [legal] requirements.*"

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[8] *See* Securities Exchange Act, §15(b)(4), 15 U.S.C. §78*o*(b)(4) (authorizing administrative enforcement proceedings against brokers and dealers) and §§21(d) and (e), 15 U.S.C. §§78u(d) and (e) (authorizing the Commission to institute civil actions in district court to enjoin violations of the Act or rules and regulations thereunder or to compel compliance with their requirements).

[9] The National Association of Securities Dealers, Inc., for example, is required by Section 15A(b)(6) of the Act, 15 U.S.C. §78*o*-3(b)(6), to have rules designed not only "to prevent fraudulent and manipulative acts and practices," but also "to promote just and equitable principles of trade . . . ." An identical obligation is imposed by §6(b)(5), 15 U.S.C. §78f(b)(5), upon securities exchanges registered with the Commission. This and the related requirement of §6(d), 15 U.S.C. §78f(d), "that an exchange's rules be 'just and adequate to insure fair dealing and to protect investors,' has obvious relevance to the area of rules regulating the conduct of an exchange's members." *Silver* v. *NYSE*, 373 U.S. 341, 353 (1963).

[10] *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Ware*, 414 U.S. 117, 127 (1973); *Gordon* v. *NYSE*, 422 U.S. 659, 667 (1975). *See Silver* v. *NYSE, supra*, 373 U.S. at 352.

This "fundamental pattern established in 1934 has not been essentially changed since then . . . ."[11]

The Commission has also formally reported to the Congress upon both "[t]he legal restraints and [the] ethical standards surrounding the securities industry."[12] These obligations, it observed, are not defined entirely as a matter of law, but are reflected as well "in the rules, regulations and practices of the national securities exchanges and the National Association of Securities Dealers, Inc." And it specifically noted—as Judge Wright did not—that there are "significant distinctions between actual legal obligations and ethical ideals." 1 Special Study at 237-238.

In view of the foregoing, it is not surprising that no prior judicial interpretation of any of the statutory provisions relating to brokers and dealers has gone so far as even to hint at a duty so broad as the one Judge Wright has articulated. Some of those decisions upon which Judge Wright relies relate to obligations indisputably owed by broker-dealers—but owed to their customers alone, not to the public or to the Commission; the remaining decisions he cites concern issues not involving the obligations of brokers or dealers at all.[13]

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[11] *See* S. Rep. No. 94-75, 94th Cong., 1st Sess. 22-23 (1975) (emphasis added); S. Rep. No. 93-865, 93d Cong., 2d Sess. 19 (1974) (emphasis added). *Accord* H.R. Rep. No. 94-123, 94th Cong., 1st Sess. 48 (1975); H.R. Rep. No. 93-1476, 93d Cong., 2d Sess. 45 (1974).

[12] Report of the Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963) (hereinafter "Special Study"). *See generally*, 1 Special Study at 237-240 (Legal and ethical obligation of the industry to the public), 302-308 (Federal controls over selling practices), 308-314 (NASD controls over selling practices), 314-321 (NYSE controls over selling practices), and 321-322 (Other exchanges' controls over selling practices).

[13] In *Charles Hughes & Co.* v. *SEC*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944), and *In re Duker & Duker*, 6 S.E.C. 386 (1939), it was held fraudulent for a broker-dealer to sell securities to its customers at unreasonable prices. Similarly, in *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), "scalping" by an investment adviser—its having traded on the market impact of its own recommendations—was held to operate as a fraud or deceit upon its clients and prospective clients. And the defendant's conviction in *United States* v. *Naftalin, supra*, 441 U.S. 768, had nothing to do with

B. *Strong public policy considerations require the explicit rejection by this Court of the standard Judge Wright would apply to govern the conduct of brokers and dealers.*

Judge Wright has inferred from the securities laws taken as a whole an unqualified duty of broker-dealers to disclose-or-refrain whenever they are aware of material facts not generally known to the public and to report to the Commission the use of those facts by others. *See* 681 F.2d at 841-842. This principle would disable broker-dealers—who necessarily must, and constantly do, have access to non-inside information not generally known to the public—from performing many normal and beneficial market-facilitating functions. It would penalize analytical excellence, impair market efficiency and place in legal jeopardy those analysts who have sufficient insight to observe values not generally perceived or to recognize the existence of unsoundness or even fraud in securities before the common crowd. It would inhibit if not prevent confidential communications between issuers of securities and the broker-dealers who act as their investment bankers. And it would charge broker-dealers with law enforcement obligations that the Congress has specifically assigned to the Commission and the self-regulatory organizations.

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the fact that he was president of a broker-dealer; it was the result, instead, of fraud he had practiced as a customer of five other brokerage firms.

Even further removed from the facts of this case are *O'Neill* v. *Maytag*, 339 F.2d 764 (2d. Cir. 1964), and *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), upon which Judge Wright also relies. Both were shareholders' derivative actions against corporate insiders. Neither of those cases nor *Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462 (1977)—raising an issue of corporate mismanagement—involved any question concerning the duties of brokers or dealers.

Judge Wright relies upon *O'Neill* v. *Maytag*, *supra*, 330 F.2d at 768-769, as suggesting "that Rule 10b-5, as applied to broker-dealers, might reach the sort of non-deceptive breach of fiduciary duty that does not come within the rule as applied to corporate managers." 681 F.2d at 840. But the language upon which he relies merely reserved that question and, in any event, the question reserved has been resolved to the contrary by this Court's opinion in *Santa Fe Indus., Inc.* v. *Green*, *supra*.

1. Judge Wright's principle would override the Congressional judgment and the rulemaking decisions of the Commission and would compel broker-dealers who perform essential market functions to forego informational advantages that have been found compatible with the public interest.

The Commission and the Congress have both noted on several occasions that the effectiveness of the securities markets is largely dependent upon the participation of securities dealers, such as "[s]pecialists, block positioners and floor traders, who . . . contribute to the public nature of securities markets by risking their capital to absorb imbalances in supply and demand."[14] The functions performed by these particular broker-

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[14] *See Adoption of Securities Exchange Act Rule 19b-2, Concerning the Utilization of Membership on National Securities Exchanges for Public Purposes,* Securities Exchange Act Release No. 9950 (Jan. 16, 1973), 38 Fed. Reg. 3902, 3918 (Feb. 8, 1973). *Accord, Securities Transactions by Members of National Securities Exchanges,* Securities Exchange Act Release No. 15533 (Jan. 29, 1979), 44 Fed. Reg. 6084, 6088-6091 (1979); S. Rep. No. 94-75, *supra,* at 68, 99; H.R. Rep. No. 94-123, *supra,* at 57-72.

A "specialist" is a member of an exchange charged with the responsibility to maintain a fair and orderly market in those stocks assigned to it. Among other things, a specialist may be required to effect purchases and sales of securities on its own behalf in order to minimize temporary disparities between supply and demand. Specialists also receive and hold "limit orders"—that is, orders to buy or sell a stock if the market should reach a specified price. *See* 2 Special Study, *supra* n.12, at 47.

A "block positioner" is a broker-dealer in securities that facilitates the purchase and sale of large quantities of various securities, often by committing its own capital to buy a portion of the total number of securities involved. *See* Securities Exchange Act Release No. 15533, *supra,* 44 Fed. Reg. at 6088-6089. Although there is no consistently-applied definition of the term, a "block" of stock generally signifies at least 10,000 shares, or a quantity of stock with a current value of at least $200,000. *Id.,* 44 Fed. Reg. at 6089 n.45.

A "floor trader" is a member of an exchange that regularly effects transactions for its own account on the exchange floor. *See* 2 Special Study, *supra* n.12, at 47.

Other securities dealers include: over-the-counter market makers, who are responsible for maintaining a continuous marketplace for securities in the non-exchange market; odd-lot dealers, exchange members that specialize in facilitating transactions in units of less than 100 shares; *bona fide* arbitrageurs, who regularly effect proprietary trades seeking to obtain a profit from the disparity in prices available in two markets for a security and its equivalent; and risk arbitrageurs,

dealers are "necessary" in order to "increase the depth, liquidity and orderliness of trading markets, enabling investors to implement trading decisions with relative ease and confidence."[15]

Because of their central position in the markets, however, these broker-dealers must often engage in securities transactions while possessing valuable non-inside information not generally known to the public. This information relates, for example, to the (i) volume and type of order flow in a particular security; (ii) existing bids and offers on a specialist's "book";[16] (iii) inventory of a block positioner, particularly blocks of stock that are to be "liquidated" or "laid off"; (iv) positions of arbitrageurs and risk arbitrageurs; and (v) institutional interest in the purchase or sale of blocks of stock. In many situations this information is clearly material.

In view of the benefits they confer, the advantage that the market professionals gain in these circumstances is not viewed as hostile to the provisions or objectives of the Securities Exchange Act. The Commission has recognized that

> "market professionals have been permitted to enjoy these market information and competitive advantages because they have obligations to the markets for the securities that they trade and have made significant contributions to the

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who regularly effect proprietary trades in a security that is, or may be, the subject of a tender offer, or other corporate reorganization, with a view toward the eventual tender or sale of such a security. *See* Securities Exchange Act Release No. 15533, *supra*, 44 Fed. Reg. at 6089-6090.

[15] *See* Securities Exchange Act Release No. 9950, *supra*, 38 *Fed. Reg.* at 3918; *accord*, 8 Securities and Exchange Commission, *Institutional Investor Study Report*, H.R. Doc. No. 64, 92d Cong., 1st Sess. at xxii (1971).

[16] A specialist's "book" is a book in which he enters, as a broker, limited price orders he has received from others to purchase or sell a specific security, at a specific price that is either higher or lower than the existing market in that security, for execution at a later time if the market moves to the price designated in such orders. The information in a specialist's book has an "importance beyond that of a mere repository of unexecuted agency orders. It serves as the indicator of public interest in a particular security." 2 Special Study, *supra* n.12, at 76.

> continuity, liquidity and depth of the markets for those securities."[17]

Thus, the Act vests in the Commission and in the self regulatory agencies broad authority, through appropriate regulation, to reconcile the possession and use by broker-dealers of valuable nonpublic trading information with the express statutory objective "to insure the maintenance of fair and honest [securities] markets . . . ."[18]

For example, as this Court recognized in *Chiarella, supra,* 445 U.S. at 233 n.16, Congress has expressly exempted specialists from the general statutory prohibition, set forth in Section 11(a)(1) of the Act, 15 U.S.C. §78k(a)(1), against members of a national securities exchange effecting transactions on the exchange for their own account. It specifically observed, 445 U.S. at 233 n.16, that

> "[t]he exception is based upon Congress' recognition that specialists contribute to a fair and orderly marketplace at the same time they exploit the informational advantage that comes from their possession of buy and sell orders."

And, based upon "[s]imilar concerns with the functioning of the market," Congress was recognized also to have exempted from the general prohibition against member trading "market

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[17] Securities and Exchange Commission, *Report of the Special Study of the Options Markets,* House Comm. on Int. and For. Commerce, Comm. Print No. IFC3, 96th Cong., 1st Sess. 1-4 (1978); *accord* 2 Special Study, *supra* n.12, at 76-83, 90, 127-128, 135, 203-242; *In re Albert Fried & Co.,* Securities Exchange Act Release No. 15293 (Nov. 3, 1978), 16 SEC Docket 100, 104 (Nov. 21, 1978) (The "*quid pro quo*" for conferring these advantages "has been the imposition of regulation to assure that in trading for his own account . . . [a dealer] uses those privileges for the benefit of the market generally . . . .").

[18] Section 2 of the Securities Exchange Act as originally passed, P.L. No. 291, §2, 73d Cong., 2d Sess. (1934).

makers, block positioners, registered odd-lot dealers, bona fide arbitrageurs and risk arbitrageurs . . . ." *Id.* [19]

2. Judge Wright's formulation would provide a substantial disincentive to security analysis—a separate and equally significant market function performed by employees of broker-dealers:

> "Exploration for relevant corporate and economic information is a service of value in the functioning of the market. If the information is related to the assets or expected performance of the enterprise, the sooner it is found, the more accurately it is appraised, and the more immediately it induces a purchase or sale, the more precisely will the market price of the securities correspond to the value of the enterprise."[20]

Thus, through careful research and evaluation of publicly available data, together with outside investigation which may include interviews with an issuer's representatives, the analyst will build a "mosaic" of information. [21]

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[19] *See* §11(a)(1), 15 U.S.C. §78k(a)(1); S. Rep. No. 94-75, 94th Cong., 1st Sess. 99 (1975). *See also* Securities Exchange Act Release No. 9950, 38 Fed. Reg. 3902, 3918 (1973). Similarly, Section 11(b) of the Act, as originally enacted, P.L. 291, §11(b), 73d Cong., 2d Sess. (1934), authorized the various stock exchanges to adopt rules which would permit "the registration of members as odd-lot dealers or specialists, or both," S. Rep. No. 1455, 73d Cong., 2d Sess. 100 (1934), and allow such trading "for their own account as may be reasonably necessary to permit them to maintain a fair and orderly market," *id.* at 30. Section 11(b) was amended in 1975 (P.L. No. 94-29, 94th Cong., 1st Sess. (1978)) "to provide . . . greater flexibility in prescribing a specialist's obligations in a national market system," S. Rep. No. 94-75, *supra*, at 100, by deletion of the original provision allowing members' trading for their own accounts only to the extent necessary for the maintenance of a fair and orderly market. Significantly, although the Act contemplates that specialists could and will trade for their own accounts, under Section 11(b) they are generally "forbidden to reveal information in respect to orders placed with them . . . ." S. Rep. No. 1455, *supra*, at 100.

[20] Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 Harvard L. Rev. 322, 341 (1979).

[21] SEC Opinion, *supra*, at 83,947. *See also* Solomon and Wilke, *Securities Professionals and Rule 10b-5: Legal Standards, Industry Practices, Preventative Guidelines and Proposals for Reform*, 43 Fordham L. Rev. 505, 527-528 (1975).

As we noted above, page 4, the Commission, in its decision below, expressly recognized the important function served by securities analysts and the significant enhancement of market efficiency which results from effective analytical research and investigation. The Commission held, however, that a line must be drawn where an analyst comes into possession of material, non-public, "inside" information—in which case the analyst, like anyone else, is "constrained" by what the commission characterized as the "well-established proscriptions of the federal securities laws,"[22] requiring him either to publicly disclose the information or to refrain from trading or inducing trades by others. Thus, the Commission balanced the public interest in market efficiency, which results from vigorous investigatory analytical efforts, against the perception underlying the insider trading prohibition—that investor confidence in the marketplace will significantly be enhanced by forbidding the private use of inside information.

Judge Wright's decision ignores these factors and obliterates this distinction. Regardless of whether inside information is involved or the analyst has any nexus to the corporation or to its insiders, the principle he has articulated would compel any broker-dealer, whose employee has by analysis reached conclusions different from those generally prevalent in the public markets, to disclose that analyst's conclusions to the public or to refrain from trading or counselling others to trade. This is the context in which the analyst has the greatest value and for which he is most justly entitled to commendation and reward;[23] this is the situation in which his efforts and the resulting transactions will enhance market efficiency by helping to bring market prices in line with actual values.[24] Whatever

[22] SEC Opinion, *supra*, at 83,950.

[23] *See* Subcommittees of American Bar Association, Section of Corporation, Banking, and Business Law, Committee on Federal Regulation of Securities, *Comment Letter on Material Non-Public Information*, (Oct. 15, 1973), reprinted in 1 Sec. Reg. L. J. 328, 346 (1974).

[24] *See* 1 *Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission*, House Comm. on Int. and For. Commerce, Committee Print No. 29, 95th Cong., 1st Sess. 63 (1977).

may have been the appreciation, intent or hope of the Commission in its disposition of this case (expressed in the SEC Opinion, *supra*, at 83,950), the duty formulated by Judge Wright will necessarily "hamper legitimate, investigative securities analysis," *id.*

3. As already noted, Judge Wright's transposition of ethical standards into what he perceives to be a legal duty on the part of broker-dealers to the public at large finds no support in the federal securities laws or their legislative history or in the judicial decisions. Indeed, Judge Wright has done what this Court specifically proscribed in *Chiarella, supra,* 445 U.S. at 231: he has created a "duty to everyone." Unless Judge Wright's views are expressly rejected, broker-dealer participants in the nation's capital markets, who deal professionally with instantaneous decisions against constantly changing prices based on a cluster of public and non-public non-inside information, would be paralyzed by a duty to cease market activities or to sift and make public disclosure, at their peril, of the material non-public portion of that information. Nowhere else in our society, insofar as we are aware, has so disabling a duty to the public at large been imposed on all members of an industry solely because of the business in which they are engaged. Neither Congress nor any court has ever seriously considered imposition of such a duty, much less adopted one.

But Judge Wright did not stop there. In addition to a duty to the public at large, he would also have these ethical standards give rise to a legal duty of broker-dealers promptly to report all material non-public information, both inside and non-inside information, to the Commission— in effect placing the hat and badge of a "policeman" on each individual member of a private, albeit heavily regulated, industry. One consequence, among many, would be the termination of broker-dealers' ability to act as "safe repositories of [investment banking] client confidences," *United States* v. *Newman, supra,* 664 F.2d at 17, on which rest the professional reputations of those broker-dealers who act as investment bankers. The underwriting of securities issues, the initiation and negotiation of

business combinations and divestitures, and the rendering of financial consulting services to business enterprises large and small, all depend on investment bankers being given access to confidential inside information, with accepted constraints on the use of such information. An obligation upon the investment banker to report that information to the Commission would destroy the clients' assurance of confidentiality and effectively preclude the informational interchange which is essential to the performance of investment banking functions.

No statute, Commission rule or judicial decision places such an onerous burden of affirmative police action on private persons in the securities industry or elsewhere. The Securities Exchange Act imposes regulatory and enforcement responsibilities on the self-regulatory organizations, not on their broker-dealer members. It is the Commission and the securities self-regulatory organizations, not broker-dealers, that have the legal obligation to investigate and determine the existence of securities law violations committed by others.[25] To impose a similar obligation on broker-dealers would make each broker-dealer the policeman of securities law compliance by all others with whom they come into professional contact—the companies whose securities they analyze or for whom they act as investment bankers as well as other broker-dealers. The mutual suspicion so engendered would place a rending strain on the fabric of the nation's capital markets.

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[25] Of course, a broker-dealer may be sanctioned if it has "failed reasonably to supervise" its own employees. *See* Securities Exchange Act §15(b)(4)(E), 15 U.S.C. §78*o*(b)(4)(E).

CONCLUSION

For the foregoing reasons, this Court should expressly reject the concept of a general duty owed by brokers and dealers to the public at large and to the Commission and the erroneous theory upon which it is based.

Respectfully submitted,

EDWARD H. FLEISCHMAN
RICHARD E. NATHAN
MARTIN P. UNGER

GASTON SNOW BEEKMAN
& BOGUE
14 Wall Street
New York, N.Y. 10005
Attorneys for Securities Industry Association

WILLIAM J. FITZPATRICK
General Counsel
RONALD T. CARMAN
Assistant General Counsel,

SECURITIES INDUSTRY
ASSOCIATION
120 Broadway
New York, N.Y. 10271

Of Counsel

December 30, 1982

QUESTION PRESENTED

The United States will address the following question:

Whether a recipient of nonpublic information concerning ongoing criminal conduct within a corporation violates the antifraud provisions of the federal securities laws by transmitting that information to other persons, including persons who may use it in making investment decisions, when the recipient of the information has no fiduciary relationship with the securityholders of the corporation and there is no element of misappropriation in transmitting or utilizing the information.

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In the Supreme Court of the United States

OCTOBER TERM, 1982

No. 82-276

RAYMOND L. DIRKS, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE IN SUPPORT OF REVERSAL

INTEREST OF THE UNITED STATES

The court of appeals has affirmed an order of the Securities and Exchange Commission censuring petitioner for violating the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), based on his transmittal of nonpublic information concerning an ongoing corporate crime. The United States and the Commission share enforcement responsibilities under Section 10(b) and Section 17(a). See 15 U.S.C. 77t(b), 78*o*(b)(4), 78u(d), 78aa and 78ff. The United States therefore has an interest in the correct interpretation of the antifraud provisions at issue in this case. See *Chiarella* v. *United States*, 445 U.S. 222 (1980).

As reflected in their past enforcement activities, the United States and the Commission are in general agree-

ment about the scope and application of the antifraud provisions. The disagreement in the present case is a narrow one. It arises from the Commission's application of the well-established rule against tipping inside information to petitioner's dissemination of evidence of crime. In the view of the United States, the Commission's order censuring petitioner cannot be reconciled with this Court's decision in *Chiarella* v. *United States*, *supra*, and threatens to impair private initiative in uncovering violations of federal law.

STATEMENT

Petitioner Dirks is a securities analyst, "well-known for his investigative talents," who researched insurance company securities (Pet. App. B-3). In March 1973, petitioner applied those investigative talents to uncover a major fraud perpetrated by the officers of a publicly-owned insurance company. As the court of appeals observed, "in two weeks of concerted effort, at times resembling something from detective fiction, Dirks investigated and confirmed rumors of massive fraud by the Equity Funding Corporation of America (Equity Funding), an insurance holding company whose stock traded on the New York Stock Exchange. Largely thanks to Dirks one of the most infamous frauds in recent memory was uncovered and exposed * * *" (Pet. App. A-3; footnote omitted). Despite his efforts to uncover and expose the criminal scheme at Equity Funding, the Securities and Exchange Commission charged petitioner with "tipping" material inside information in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a). Following an administrative hearing, the Commission entered an order finding petitioner to be in violation of those provisions (Pet. App. B-1 to B-27) and the court of appeals affirmed (Pet. App. A-1 to A-41).

1. Petitioner first learned of the fraud at Equity Funding from a former officer of the company, Ronald Secrist, who met with him for several hours on March 7, 1973. "Secrist made a series of detailed but nearly incredible allegations about Equity Funding" (Pet. App. A-5), including allegations that the company had produced large numbers of spurious insurance policies to inflate its sales revenues and that "its top officers had Mafia connections which they used to threaten the lives of employees who objected to the fabrications" (*ibid.*; Pet. App. B-3 to B-5 & n.8). Secrist urged petitioner to verify the existence of the fraud and then expose it (J.A. 14-15). He expected petitioner to transmit evidence of the fraud to "his firm's customers" and "clients" (J.A. 25), thereby triggering large-volume securities sales that would lead to a full investigation: "by jarring the stock, he would jar the corporat[ion]—this was my plan—he would jar the corporate officers and would also rattle the Wall Street financial community to the extent that someone would take action very quickly" (J.A. 16). Secrist believed that selling pressure would cause the price of Equity Funding stock to "drop close to zero very quickly" (*id.* at 26-27), and thus "reveal the fraud to the world" and "prevent its continuation" (*id.* at 27, 258).

During their initial meeting, petitioner sought and obtained Secrist's permission to convey evidence of the fraud to the *Wall Street Journal* (J.A. 22, 27-28, 37-38). Secrist warned, however, that merely presenting the information to regulatory authorities, including the SEC, would be abortive (J.A. 15-16, 36-37; Pet. App. B-4). Secrist stated that employees who attempted to do this in the past had been "brushed aside with a comment that that's a ridiculous story" (J.A. 16); those employees also found that the information was sometimes relayed back to Equity Funding and that "they were placed in personal jeopardy as a result of having gone there" (J.A. 22-25, 36-38, 66-67, 229; Pet. App. A-9 to A-10 n.6, B-4 to B-5 n.8).

Petitioner commenced his investigation by examining publicly available financial data and by contacting other members of the investment community to see if they had learned of the fraud allegations (Pet. App. A-5; J.A. 71-72). This inquiry proved fruitless. Petitioner then decided to personally investigate the allegations by flying from New York to Los Angeles to interview present and former employees of Equity Funding (Pet. App. A-6). Despite repeated denials of wrongdoing by the company's senior management (*ibid.*; J.A. 237-238), petitioner obtained substantial corroboration of the charges of fraud from one current and six former Equity Funding employees (Pet. App. B-9).

Throughout his investigation, petitioner spoke with a number of investors and analysts—"some because he hoped they might give him information or support, others because they were clients or potential clients and his records showed they were interested in information about Equity Funding, and still others simply because, having heard rumors about his investigation, they called him" (Pet. App. A-7; J.A. 71-72, 245-246). Not surprisingly, some of the persons who spoke with petitioner and learned of the alleged fraud sold their holdings of Equity Funding securities. Five investment advisers who communicated with petitioner liquidated securities worth more than $16 million (Pet. App. A-8).

In addition to interviewing former employees of Equity Funding, petitioner also met with Equity Funding's present and former auditors in an attempt to spread word of the fraud and bring it to a halt. As the Commission explained (Pet. App. B-9 n.12):

> Dirks also learned that [Equity Funding's] auditors were about to release certified financial statements for the company on March 26. He immediately contacted them and apprised them of the fraud allegations, hoping that they would withhold release of their report and seek a halt in the trading of [Equity Funding] securities. Instead, the auditors * * *

> merely reported Dirks' allegations to [Equity Funding's] management.

While petitioner believed that his revelations to the auditors would lead to a trading halt by the "New York Stock Exchange" or "the SEC" (J.A. 42-46, 59, 243-244), neither the current nor the former auditors were able to achieve that result (J.A. 56-59).[1]

As early as March 12, 1973, petitioner also attempted to communicate his evidence to the *Wall Street Journal* (Pet. App. B-5; J.A. 47, 230). "Dirks expected that a highly respected publication like the *Wall Street Journal* could be effective in helping him investigate the Secrist allegations and to expose the * * * fraud if it proved to exist" (J.A. 233). Those efforts also were unavailing (J.A. 47-56, 59-62, 270-271). As the court of appeals explained (Pet. App. A-9):

> [D]uring the entire week that Dirks was in Los Angeles investigating Equity Funding, he was also in touch regularly with William Blundell, the *Wall Street Journal*'s Los Angeles bureau chief. Dirks kept Blundell up to date on the progress of the investigation and badgered him to write a story for the *Wall Street Journal* on the allegations of fraud at Equity Funding. Blundell, however, was afraid that publishing such damaging rumors supported only by hearsay from former employees might be libelous, so he declined to write the story.

Petitioner provided Blundell with "the substance of all he knew," including his "notes" and the "names" of all witnesses (J.A. 238). Nevertheless, given the "scope of the fraud," Blundell doubted that it could have been "missed by an honest auditor" and discounted the entire allegation (J.A. 123, 136).

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[1] While communicating with the auditors, petitioner concealed his whereabouts to protect his personal safety (J.A. 243-244). When he learned that the auditors had merely conveyed his accusations back to Equity Funding's management, petitioner fled his hotel room in a " 'state of panic' " (*id.* at 244).

Increasing circulation of rumors about the fraud led petitioner to believe that it was "unlikely that [Equity Funding] stock would open for trading on Monday, March 26, because * * * trading [would] be halted by the NYSE [New York Stock Exchange]" (J.A. 244).[2] This did not occur, however, and petitioner again spoke to William Blundell of the *Wall Street Journal* and urged him to publish a story exposing the fraud. Blundell refused to do so but stated that he intended to discuss the matter with the SEC's Los Angeles Regional Office. Blundell secured petitioner's permission to propose a meeting with the SEC that would include himself and two other key witnesses (J.A. 245, 270). Petitioner then contacted the SEC and voluntarily presented all of his information at the SEC's regional office beginning on March 27 and continuing throughout the next three days (Pet. App. A-10; J.A. 62, 245).

During the two-week period in which petitioner pursued his investigation and spread word of Secrist's charges, the price of Equity Funding stock fell precipitously from $26 per share to less than $15 (Pet. App. A-10). This led the New York Stock Exchange to halt trading in the stock on March 27 (*ibid.*). Shortly thereafter, Illinois and California insurance authorities impounded Equity Funding's records and uncovered evidence of the fraud (Pet. App. A-11). Only then did the SEC file a complaint against Equity Funding and only then did the *Wall Street Journal* publish "a front page story written by Blundell but based largely on information assembled by Dirks" (Pet. App. A-11; J.A. 270-271). Three days later, Equity Funding filed a petition under Chapter X of the Bankruptcy Act (J.A. 5).

While petitioner's investigative activities succeeded in revealing in a few days that " 'one of the darlings of

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[2] As early as March 19, Secrist informed petitioner that he had reported his allegations to both state insurance regulators and the SEC. Despite his reservations about the regulators, Secrist believed that they too might take action. J.A. 50-51.

Wall Street, a company that had managed to produce continued high earnings growth for a decade, * * * was, instead, a gigantic fraud'" (Pet. App. B-22; footnote omitted), government authorities with jurisdiction over Equity Funding did not move so quickly (Pet. App. A-3).[3] As early as 1971, the SEC had received allegations of fraudulent accounting practices at Equity Funding (Pet. App. A-9 n.6; J.A. 100-114, 160-162, 270 n.49). Moreover, on March 9, 1973, an official of the California Insurance Department informed the SEC's regional office in Los Angeles of Secrist's charges of fraud (Pet. App. A-10 n.6, B-11 n.18; J.A. 91-99, 171-172, 269). The SEC's staff attorney "stated that similar allegations had been made about Equity Funding before by disgruntled employees." He nonetheless recommended "'delaying any type of inspection of the Equity Funding operations until next year * * *'" absent further corroboration (Pet. App. A-10 n.6; J.A. 95-99, 171-172). Equity Funding's Chairman—one of the principal architects of the fraud—testified that, prior to March 1973, he received no questions from auditors, state regulatory authorities, or federal regulatory authorities that suggested "they suspected there was a fraud at Equity Funding" (J.A. 116-117). When asked whether petitioner was "personally responsible for having uncovered the events at Equity Funding," he candidly stated: "I think Mr. Dirks is entitled to personal credit for that" (J.A. 115).

Following public revelation of the Equity Funding scandal, a federal grand jury in Los Angeles returned a 105 count indictment against 22 persons, including many of Equity Funding's officers and directors, alleging violations of the antifraud provisions of the federal securities laws, mail fraud, bank fraud, interstate trans-

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[3] Equity Funding had made "bogus entries in its books since 1964" (Pet. App. B-11). Of the more than $3 billion worth of life insurance ostensibly issued by Equity Funding after that time, more than $2 billion proved to be fictitious (*id.* at B-11 n.19).

portation of counterfeit securities, interstate transportation of securities obtained by fraud, and other federal felonies. Those proceedings were concluded by entry of guilty pleas or convictions after trial of all defendants for one or more of the counts against them (J.A. 5-6). Equity Funding's Chairman, Stanley Goldblum, received an eight-year prison sentence and a substantial fine (J.A. 151).

2. While the *Wall Street Journal's* reporter, William Blundell, was "nominated for a Pulitzer Prize for his coverage of the Equity Funding scandal" (Pet. App. A-11; footnote omitted), petitioner was charged by the SEC with violating the antifraud provisions of the federal securities laws based on his selective revelation of information about Equity Funding prior to general public disclosure. Following an administrative hearing, the Commission found that petitioner had "tipped" nonpublic information concerning Equity Funding in violation of those provisions. It observed that "Dirks received the information from inside corporate sources. From the nature of the information, the inference must have been obvious that his sources had received it during the course of their corporate duties, and that the company intended that it should be kept in confidence" (Pet. App. B-20; footnote omitted). The Commission added (Pet. App. B-21 n.42) that

> In tipping potential traders, Dirks breached a duty which he had assumed as a result of knowingly receiving confidential information from [Equity Funding] insiders. * * * Such a tippee breaches the fiduciary duty which he assumes from the insider when the tippee k owingly transmits the information to someone who will probably trade on the basis thereof.

The Commission reached that conclusion even though it recognized that "Dirks' informants were entitled to disclose the [Equity Funding] fraud in order to bring it to light and its perpetrators to justice" (*ibid.*).

Despite its finding of a violation, the Commission imposed only a censure—its mildest sanction—on petitioner. It observed that "it is clear that Dirks played an important role in bringing [Equity Funding's] massive fraud to light, and [that] * * * he reported the fraud allegations to [Equity Funding's] auditors and sought to have the information published in *The Wall Street Journal*" (Pet. App. B-26).

3. The court of appeals affirmed the Commission's censure order by a divided vote (Pet. App. A-1 to A-41). The court recognized both that there is "good reason to release corporate employees from their duty to keep corporate information confidential when the information concerns corporate crimes" (Pet. App. A-25), and that there is a weighty public interest in encouraging private persons to uncover evidence of criminal conduct (*id.* at A-25 to A-26; footnotes omitted):

> Both the state and the public at large have an interest in exposing corporate misconduct. Ordinarily, we would expect that official law enforcement agencies would be sufficient for that task, but this case shows that the organs of government are not always able to accomplish swift investigation of possible crimes. The press also has an historic role in discovering and exposing wrongdoing, but here, too, the press failed to move as quickly as Dirks, who had more immediate financial and reputational incentives to discover the truth about Equity Funding. Interpreting Rule 10b-5 so as to categorically prevent private sector investigators from contacting corporate employees and asking them about crimes or frauds that their employer is committing may not, in the end, serve the public interest.

Despite this concern, the court held that petitioner had engaged in fraudulent tipping in violation of the securities laws. The court concluded that since corporate employees could not themselves trade in Equity Funding securities without disclosing all material nonpublic in-

formation in their possession, petitioner was under an identical disability. The court believed that "the obligations of corporate fiduciaries pass to all those to whom they disclose their information before it has been disseminated to the public at large" (Pet. App. A-25). Thus, the court reasoned, petitioner was under a duty to make full public disclosure of his information or abstain from trading or tipping (*id.* at A-21).

INTRODUCTION AND SUMMARY OF ARGUMENT

1. This Court's recent decision in *Chiarella* v. *United States*, 445 U.S. 222, 231 (1980), establishes that the antifraud provisions of the federal securities laws forbid nondisclosure of information only when there is an "affirmative duty" to make disclosure. Congress has not enacted a "parity-of-information" requirement under these statutes (*id.* at 233), and policy arguments based on "unfairness" do not substitute for a duty to disclose that is rooted in legal principle (*id.* at 232).

The Justices of this Court unanimously agreed in *Chiarella* that there is no general duty to make disclosure before trading with or tipping material nonpublic information. Instead, such a duty arises either from the existence of a fiduciary relationship between the defendant and uninformed investors, or some act of misappropriation or conversion. See 445 U.S. at 228-235; *id.* at 238-239 (Brennan, J., concurring); *id.* at 239-245 (Burger, C.J., dissenting); *id.* at 245-247 (Blackmun, J., dissenting).

2. These principles establish that petitioner had no duty to disclose or abstain from trading or tipping. He was not a fiduciary with respect to the securityholders of Equity Funding. To the contrary, he was a complete stranger to those investors: he took no action, directly or indirectly, that would induce them to repose trust or confidence in him. Moreover, no ground exists for classifying him as a constructive fiduciary *ex malefico*. He engaged in no tortious or dishonest conduct that would

justify the imposition upon him of the obligations of a constructive trustee.

Similarly, there is no basis for concluding that petitioner misappropriated confidential information or participated in a breach of fiduciary duty, misconduct that gives rise to a duty of full disclosure. As both the Commission and the court of appeals recognized, petitioner's informants acted lawfully when they imparted their information to him, and petitioner used that information in precisely the manner that his informants expected.

3. The Commission's erroneous imposition of liability in this case has serious consequences for federal law enforcement, which frequently depends on private initiative to uncover criminal conduct. If the antifraud provisions of the federal securities laws, backed by administrative, civil, and criminal sanctions, forbid analysts to trade with or transmit evidence of crime obtained through honest investigation, then few analysts will have an incentive to invest the resources needed to investigate corporate frauds like the Equity Funding fraud. Few analysts will be willing to devote substantial resources and expose themselves to personal danger to investigate rumors of crime—as petitioner did—if they are forbidden to utilize the information they obtain until after it is fully revealed to the investing public.

Considerations of investor confidence and fairness, which have great weight in traditional insider trading cases, do not support the imposition of liability here. Petitioner's investigative activities brought to a halt a massive fraud that had victimized investors for nearly a decade, and which could have persisted undetected for many years to come. Petitioner accomplished what regulatory authorities were unable to do. Deterrence of such investigative action in the future will diminish, not increase, the confidence of the investing public. Moreover, while considerations of fairness preclude those with privileged access to confidential information from exploiting that advantage in violation of fiduciary duty, the

information obtained by petitioner was "secured by the private initiative of someone who enjoyed no privileged position with respect to access to information." Lorie, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy: A Comment*, 9 J. Legal Stud. 819, 821 (1980). Accordingly, there is no sound basis in policy for deterring analysts from exercising such private initiative in the future.

ARGUMENT

PETITIONER'S SELECTIVE TRANSMITTAL OF NONPUBLIC INFORMATION CONCERNING CRIMINAL CONDUCT AT EQUITY FUNDING WAS NOT FRAUDULENT BECAUSE PETITIONER HAD NO FIDUCIARY DUTY TO MAKE GENERAL DISCLOSURE TO SECURITYHOLDERS AND BECAUSE THERE WAS NO ELEMENT OF MISAPPROPRIATION IN TRANSMITTING OR UTILIZING THAT INFORMATION

The Commission and the court of appeals concluded that petitioner was subject to a duty to disclose to the public at large his evidence of criminal conduct or abstain from passing it on to anyone. The premise of that conclusion was that the sources of the information—present and former officers of Equity Funding—were subject to a fiduciary duty to the company's securityholders. The Commission believed that petitioner "assumed" that fiduciary duty simply by receiving the information, and that this prevented him from either tipping or trading (Pet. App. B-21 n.42). The court of appeals likewise believed that a fiduciary duty "pass[ed]" automatically to petitioner from his corporate informants (Pet. App. A-25).[4]

[4] The court of appeals articulated an alternative theory of liability based on petitioner's status as a registered broker-dealer, which the court believed to be sufficient to trigger a duty of general public disclosure (Pet. App. A-27 to A-31). That theory was not relied on by the Commission when it rendered its decision and is not relied on by the Commission in this Court as a ground for affirmance (Br. in Opp. 16). In these circumstances, there is no

In this Court, the Commission argues once again that petitioner "inherited" a fiduciary duty to Equity Funding's securityholders (Br. in Opp. 14-15). These verbal characterizations do not, however, establish an "affirmative duty to disclose" as required by *Chiarella* v. *United States*, 445 U.S. 222, 231 (1980). Moreover, treatment of petitioner's conduct as a form of fraudulent tipping threatens to significantly undermine the incentive of private persons to ferret out and reveal evidence of crime.

I. Failure To Publicly Disclose Information Before Selectively Transmitting It Or Engaging In Securities Transactions Based Upon It Is Not Fraudulent Unless There Is An Affirmative Duty To Make General Public Disclosure

1. The antifraud provisions involved in this case, Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), are key components of the government's "arsenal of flexible enforcement powers." *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 195 (1976).[5] Section 17(a) is broadly phrased "to protect against fraud and promote the free flow of information in the public dissemination of securities." *Rubin* v. *United States*, 449 U.S. 424, 431 (1981). It therefore serves to

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need for the Court to consider this alternative theory of liability (see *SEC* v. *Chenery Corp.*, 332 U.S. 194, 196 (1947)), and we do not address it in this brief.

[5] Although Section 10(b) and Section 17(a) both extend to a wide variety of fraudulent practices, there are certain differences in their coverage. See, e.g., *Aaron* v. *SEC*, 446 U.S. 680, 687-702 (1980). In determining whether there is a duty to disclose nonpublic information before trading or tipping, however, identical principles apply. Neither the Commission nor the court of appeals identified any difference between the antifraud provisions that is relevant in this respect, and the language of the provisions does not suggest any relevant difference. See Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 Harv. L. Rev. 322, 324-325 n.17 (1979).

insure "'a high standard of business ethics'" in every facet of the securities industry. *United States* v. *Naftalin*, 441 U.S. 768, 775 (1979). Similarly, Section 10(b) is a "'catchall'" provision aimed at all types of fraudulent securities practices (*Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 203), which is to be construed "'not technically and restrictively, but flexibly to effectuate its remedial purposes'" (*Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972)).

These comprehensive antifraud provisions condemn not only false statements and partial truths in connection with securities transactions, but also failures to disclose material nonpublic information when there is a duty to disclose. "Thus, administrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud * * * despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure." *Chiarella* v. *United States*, 445 U.S. 222, 230 (1980). In particular, it is well settled that "a corporate insider must abstain from trading in the shares of his corporation unless he has first disclosed all material inside information known to him." *Id.* at 227. In addition, "[t]ippees" who trade with information obtained from corporate insiders are liable under the antifraud provisions "because they have a duty not to profit from the use of inside information that they know is confidential and know or should know came from a corporate insider * * *." *Id.* at 230 n.12. As the Commission correctly explained (Pet. App. B-13 to B-14; footnote omitted), "[w]here 'tippees'—regardless of their motivation or occupation—come into possession of material 'corporate information that they know is confidential and know or should know came from a corporate insider,' they must either publicly disclose that information or refrain from trading. In addition, under aiding and abetting principles, a non-trading tipper is liable where he knew

or should have known that his tippee would be likely to trade."[6]

2. As this Court has made clear, however, liability for nondisclosure of nonpublic information is not without limitation. As a general proposition, there is no duty to disclose information to the public at large before engaging in a commercial transaction or before imparting the information to other persons. Thus, "one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so." *Chiarella* v. *United States*, *supra*, 445 U.S. at 228. This Court's decision in *Chiarella*, which reviewed the law applicable to both "inside information" cases (*id.* at 226-230) and "market information" cases (*id.* at 231-235), delineates the circumstances in which there is a duty to disclose.[7]

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[6] Although the Commission and the United States disagree about the proper application of these general principles to the facts of this case—involving the selective dissemination of evidence of crime—there is no disagreement about the legal principles themselves. Insiders, outsiders, and their tippees who misuse material confidential information in securities transactions are subject to both civil and criminal liability under the federal securities laws. In particular, corporations that issue securities, their insiders, and tippees may not trade with or selectively disseminate confidential inside information that is material in nature, whether that information has a positive or negative impact on security prices. Moreover, both the United States and the Commission agree that this Court's decision in *Chiarella* v. *United States*, *supra*, 445 U.S. at 230 n.12, which dealt with a market information issue, did not attempt to delineate the outer boundaries of tippee liability. Thus, while tippee liability may arise when a tippee is "a participant after the fact in the insider's breach of a fiduciary duty," such liability also may arise when the tippee, although properly entrusted with confidential information, himself engages in a wrongful misappropriation of that information for his personal advantage. See generally *SEC* v. *Lund*, [1981-1982] Fed. Sec. L. Rep. (CCH) ¶ 98,428 (C.D. Cal. Jan. 22, 1982).

[7] Although *Chiarella* dealt with nondisclosure of "market information" (*id.* at 235), the Court's decision rested on general princi-

a. All nine Justices of this Court agreed in *Chiarella* that there is no "general duty between all participants in market transactions to forgo actions based on material, nonpublic information" (445 U.S. at 233).[8] The Court declined to embrace "such a broad duty * * * absent some explicit evidence of congressional intent." *Ibid.* Instead, the Court adhered to the common law doctrine requiring disclosure only when there is an identifiable "affirmative duty" to divulge information. *Id.* at 228, 231. The majority concluded that such a duty "arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.'" *Id.* at 228; footnote omitted. The majority emphasized that a duty to disclose "arises from the relationship between parties * * * and not merely from one's ability to acquire information because of his position in the market." *Id.* at 231-232 n.14. Thus, an informational advantage is not fraudulent simply because it "gives certain buyers or sellers an unfair advantage over less informed buyers and sellers" (*id.* at 232). The Court noted that "neither

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ples governing all cases of nondisclosure under Section 10(b). See *id.* at 228-230. The Court drew those principles from inside information cases such as *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), as well as market information cases such as *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972). Of course, the summary of case law in *Chiarella* does not purport to be an exhaustive review of legal principles applicable in either inside or market information cases.

[8] See *id.* at 237 (Stevens, J., concurring); *id.* at 235-239 (Brennan, J., concurring); see also *id.* at 239-240 (Burger, C.J., dissenting) ("As a general rule, neither party to an arms'-length business transaction has an obligation to disclose information to the other unless the parties stand in some confidential or fiduciary relation"); *id.* at 252 n.2 (Blackmun, J., dissenting) (recognizing that there is no duty to disclose material nonpublic information obtained through the exercise of "diligence or acumen" and "honest means," as opposed to "stealth").

the Congress nor the Commission ever has adopted a parity-of-information rule" (*id.* at 233).

b. The opinions in *Chiarella* also refer to another ground for imposing a duty to disclose or abstain from trading or tipping. As explained by the Chief Justice in dissent (445 U.S. at 239-245), the common law and the federal securities laws recognize a duty to disclose or abstain whenever the defendant receives material nonpublic information—whether inside information or market information—by misappropriation, conversion, or other tortious conduct. Thus, "a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading." *Id.* at 240. This doctrine condemns informational advantages in securities transactions that are "obtained by conversion and not by legitimate economic activity that society seeks to encourage." *Id.* at 242 n.3. Justice Brennan, in his concurring opinion (*id.* at 239), found this to be a correct statement of the applicable substantive law. Justices Marshall and Blackmun, in dissent, also expressed agreement with the misappropriation theory summarized by the Chief Justice (*id.* at 245-246), and Justice Stevens, while reserving judgment on the issue, characterized the misappropriation doctrine as a "[r]espectable" one (*id.* at 238).[9]

c. The dissenting opinion of Justices Blackmun and Marshall in *Chiarella*, while agreeing that "a relationship of trust can establish a duty to disclose," and that misappropriation or conversion of confidential information for security trading is "dramatic evidence" of fraud, expressed the view that a duty to disclose also should

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[9] Following *Chiarella*, the lower courts have based findings of liability on the misappropriation doctrine articulated by the Chief Justice. See, e.g., *United States* v. *Newman*, 664 F.2d 12 (2d Cir. 1981). The majority opinion in *Chiarella* did not cast doubt on the misappropriation doctrine. Rather, it declined to address it because it "was not submitted to the jury." 445 U.S. at 236; see also *id.* at 243 n.4.

arise whenever an individual has access "to confidential information that the honest investor, no matter how diligently he tried, could not legally obtain." *Id.* at 246-247. This approach would prohibit trading on or tipping of information that is legally unavailable to other investors, while assuring that informational advantages "obtained by honest means reap their full reward." *Id.* at 252 n.2.[10]

In short, the Justices of this Court unanimously have agreed that informational advantages, standing by themselves, do not offend the antifraud provisions of the federal securities laws. Merely characterizing a party as someone with access to material nonpublic information therefore does not suffice to impose a duty to disclose or abstain from trading or tipping, since the "rationale for that limitation is unrelated to the existence of a duty to disclose." *Id.* at 231; footnote omitted. In the present case, both the Commission and the court of appeals failed to analyze the threshold question whether petitioner was subject to a duty to disclose. They simply assumed that because *other persons*—corporate officials with specific employment relationships—were subject to a fiduciary duty to stockholders, that petitioner stood "in their shoes" (Pet. App. B-21 n.42). As *Chiarella* demonstrates, however, a duty to disclose does not arise simply from this kind of verbal characterization.

II. Petitioner Was Not Subject To A Duty To Make General Public Disclosure Of Information Concerning The Equity Funding Fraud Before Passing That Information On To Other Persons

The Commission pretermitted any detailed analysis of the threshold "duty" question because it believed that the present case involved a familiar application of the rule against tipping "inside information" (Pet. App. B-11 to B-12). In fact, however, this case does not. The present

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[10] This broad interpretation was rejected by the majority (see 445 U.S. at 235 n.20).

case involves transmittal of evidence of an ongoing criminal scheme, not inside information of the kind considered in the Commission's past decisions.[11] As we demonstrate below, the nature of this information is vitally relevant to a proper analysis of the question whether petitioner was subject to a duty to make public disclosure before tipping or trading.

1. Initially, the question arises whether petitioner was subject to a duty to disclose or abstain from tipping or trading because he was a "fiduciary" as described in *Chiarella*. If, in fact, he occupied a fiduciary relationship with respect to the shareholders of Equity Funding, then it would be incumbent upon him to make full disclosure and to deal with them with utmost candor, regardless of the nature of the information at issue.[12]

In fact, however, petitioner was not a "fiduciary" with respect to the shareholders of Equity Funding. Unless that term is reduced to a mere conclusory label, the inference is unmistakable that petitioner, like the defendant in *Chiarella*, was a "stranger" to the corporation's shareholders. "He was not their agent, he was not a fiduciary, he was not a person in whom the [investors] had placed their trust and confidence." 445 U.S. at 232-233.[13]

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[11] Accordingly, the disagreement between the United States and the Commission herein relates only to the *extension* of well-established legal principles to the facts of this unusual case. The United States agrees with, and intends to continue to enforce through criminal prosecution where appropriate, the legal requirements established in the Commission's past decisions.

[12] Thus, regardless of the classification of information as inside information, market information, or evidence of crime, a fiduciary would not be permitted to take advantage of uninformed beneficiaries by dealing with them in securities transactions. For example, Ronald Secrist and the other officers and employees of Equity Funding were disabled from profiting at the expense of shareholders without full disclosure. *Chiarella* v. *United States*, *supra*, 445 U.S. at 227-228.

[13] "The horizon is not unlimited * * *. One cannot manufacture a representation for all potential defendants that the public ex-

As Professor Scott has observed, "[a] fiduciary is a person who undertakes to act in the interest of another person." Scott, *The Fiduciary Principle*, 37 Calif. L. Rev. 539, 540 (1949). Ordinarily, "acceptance" of a fiduciary relationship and agreement to act on behalf of the beneficiaries is required to subject a person to fiduciary duties. 1 A. Scott, *The Law of Trusts* 44, 287 (3d ed. 1967); *Restatement (Second) of Agency* § 15 (1958). There is no evidence that petitioner ever agreed to act on behalf of the stockholders of Equity Funding, or that he induced them, directly or indirectly, to place their trust and confidence in him.

A person also may be deemed a constructive fiduciary *ex malefico* when necessary to redress tortious conduct or preserve property rights. Thus, a constructive fiduciary relationship may be implied when unjust enrichment results from misappropriation or improper withholding of property, or when the defendant is guilty of fraud, duress or other similar misconduct. *Restatement of the Law of Restitution* §§ 160, 166 & comments (1937); 5 A. Scott, *supra*, at 3412-3417, 3438-3441; G. Bogert, *The Law of Trusts and Trustees* §§ 471, 482 (2d ed. 1960); *Snepp* v. *United States*, 444 U.S. 507, 515 (1980). More specifically, a person may become a constructive fiduciary if he knowingly acquires "confidential information which is 'owned' by someone else." *Schein* v. *Chasen*, 478 F.2d 817, 823 (2d Cir. 1973). Thus, a "person who, with notice that an agent is thereby violating his duty to his principal, receives confidential information from the agent, may be [deemed] * * * a constructive trustee." *Restatement (Second) of Agency*, *supra*, § 312 comment *c.*; *Restatement of the Law of Restitution*, *supra*, § 201(2)

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pects them to disclose nonpublic information, a relationship of trust and confidence therefore exists, and a duty to disclose is thus implied. Mr. Chiarella would have been held guilty had this approach been applied to printers, but he was not." 5A A. Jacobs, *Litigation and Practice Under Rule 10b-5* 3-433 (2d ed. 1982).

& comment *b*. Accord, III L. Loss, *Securities Regulation* 1450-1451 & n.19 (2d ed. 1961).[14]

As we demonstrate in greater detail below, petitioner is no more a constructive fiduciary *ex malefico* than he is a consensual fiduciary. He did not engage in misappropriation, conversion, or fraud, he did not participate in any breach of fiduciary duty, and he did not obtain confidential information "owned" by someone else. He was not, therefore, a fiduciary *ex malefico* subject to a duty to abstain from trading or tipping prior to the general public announcement of the information in his possession.

2. As the Chief Justice observed in *Chiarella*, *supra*, 445 U.S. at 239-245, a person who misappropriates confidential information may be required to make full disclosure before engaging in a commercial transaction pursuant to traditional doctrines of the law of deceit, which also apply under the federal securities laws. See also Barry, *The Economics of Outside Information and Rule 10b-5*, 129 U. Pa. L. Rev. 1307, 1363-1369 (1981). The facts of the present case, however, clearly show that petitioner did not engage in any form of misappropriation and did not participate in any breach of fiduciary duty.

The Commission's past cases, considering allegations of insider trading, all have involved misappropriation of confidential information. In the seminal case of *Cady, Roberts & Co.*, *supra*, the Commission emphasized that the duty to disclose or abstain from trading or tipping rested on use of "information intended to be available only for a corporate purpose and not for the personal benefit of anyone." 40 S.E.C. at 912. Accord, *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc); *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 232, 237-238 (2d Cir.

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[14] Conversely, a "person who has such information without notice of its confidential nature * * * is not subject to liability for revealing the secret to others." *Restatement (Second) of Agency*, *supra*, § 312 comment c.

1974). See also *In re Van Alstyne, Noel & Co.*, 43 S.E.C. 1080, 1083 & n.3 (1969) (involving "confidential" reports " 'prepared for management use only,' " which were not to be " 'used for public distribution or private gain' "); *In re Blyth & Co.*, 43 S.E.C. 1037, 1039-1040 & n.3 (1969) (involving "confidential" information "intended to be kept non-public until a predetermined time and then disseminated pursuant to established official procedures"); *In re Investors Management Co.*, 44 S.E.C. 633, 640-641 & n.18, 645, 648-651 (1971) (involving confidential information "obtained improperly" by tippees).[15] And finally, in *Chiarella*, this Court likewise characterized inside information as confidential "information intended to be available only for a corporate purpose." 445 U.S. at 227.

In contrast to the information involved in the foregoing cases, the information at issue in this case—evidence of a massive, ongoing criminal scheme—was not "confidential" information available "only for a corporate purpose." Evidence of crime is not the private property of anyone. It is not amenable to "conversion." Those who discover it and spread the news to others are not guilty of misappropriation or theft. Quite to the contrary, any effort to disseminate such information is encouraged by the law, while efforts to preserve its secrecy are strictly forbidden.

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[15] The Commission stated in *Investors Management Co.* (44 S.E.C. at 641 n.18) that there clearly is a duty to disclose or abstain from trading or tipping whenever the recipient of information knows or has reason to know that "the information was obtained by industrial espionage, commercial bribery, or the like," and whenever the recipient comes into possession of "information which [he] has reason to know is intended to be confidential." However, the Commission would "not attach responsibility with respect to information which is obtained by general observation or analysis." See also 44 S.E.C. at 648-651 & n.2 (Commissioner Smith, concurring). Commissioner Smith warned against broader legal interpretations that would "penalize or thwart the quest for new knowledge by analysts and researchers." *Id.* at 649.

As the Commission recognized, Secrist and the other employees of Equity Funding acted properly in disclosing evidence of the Equity Funding fraud to petitioner. "Dirks' informants were entitled to disclose the [Equity Funding] fraud in order to bring it to light and its perpetrators to justice" (Pet. App. B-21 n.42). In the words of the court of appeals, the law has "good reason to" release corporate employees from their duty to keep corporate information confidential when the information concerns corporate crimes or frauds" (Pet. App. A-25). See also *Restatement (Second) of Agency*, *supra*, § 395 comment *f.*: "An agent is privileged to reveal information confidentially acquired by him in the course of his agency in the protection of a superior interest * * *. Thus, if the confidential information is to the effect that the principal is committing or is about to commit a crime, the agent is under no duty not to reveal it." See also *Restatement (Second) of Trusts* § 62 & comments *a.* and *b.* (1959). Beyond this, any attempt to cover up or preserve the confidentiality of evidence of an ongoing crime would be contrary to public policy and a misprision of felony. See *Roberts* v. *United States*, 445 U.S. 552, 557-558 & n.5 (1980), noting that "[c]oncealment of crime has been condemned throughout our history," and that affirmative efforts to preserve the secrecy of a criminal conspiracy constitute a violation of 18 U.S.C. 4. Accordingly, there is no basis whatsoever for viewing the revelations of Secrist and the other Equity Funding employees as an improper disclosure of "confidential" information or a breach of fiduciary duty, and petitioner cannot be characterized "as a participant after the fact in the insider's breach of a fiduciary duty" (*Chiarella* v. *United States*, *supra*, 445 U.S. at 230 n.12).

Nor can petitioner's use of the information, after it was divulged to him, be viewed as any type of misappropriation or conversion. Because evidence of crime is not anyone's private property, and because public policy favors its unfettered dissemination, it is doubtful whether

restrictions could be placed on petitioner in communicating it to other persons. In any event, the record establishes unequivocally that petitioner used the information in precisely the manner intended by his informants—to set up the "hue and cry" (*Roberts* v. *United States*, *supra*, 445 U.S. at 557). Secrist, who originally provided the information and monitored its use, intended petitioner to divulge the information to institutional traders who would precipitate large-scale market activity, and thereby hasten the investigation and termination of the fraud (see page 3, *infra*). Secrist also gave his permission to convey the information to the *Wall Street Journal* (*ibid.*). Petitioner's communications with the auditors (see *id.* at 4-5) further advanced Secrist's stated objective of exposing the fraud. And, precisely as Secrist anticipated, petitioner's activities quickly achieved the desired objective while regulatory authorities lagged behind. Far from inflicting a tortious injury on the corporation, petitioner's actions served to expose and terminate corrupt wrongdoing by some of its highest ranking officials.

In short, there is virtually no basis for suggesting that petitioner engaged in misappropriation or other tortious conduct that would impose upon him a duty to guarantee disclosure to the public at large before disseminating information about the Equity Funding scandal.[16]

3. Finally, it is significant to note that, even under the broadest formulation of the "abstain or disclose" doctrine articulated in the *Chiarella* case, petitioner still is immune from liability. The dissenting opinion of Justices

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[16] In other situations, a question may arise whether a recipient of information has obtained evidence disclosing criminal conduct as opposed to mere "bad news" which, in certain limited circumstances, is properly treated as confidential by a corporation. See note 24, *infra*. The test, in such cases, is whether the recipient "know[s]" or "has reason to know" that the information is "confidential" corporate information, rather than evidence of a crime—which is subject to no legitimate expectation of secrecy. See *In re Investors Management Co.*, *supra*, 44 S.E.C. at 641 & n.18, 650 & n.2.

Blackmun and Marshall would prohibit trading on or tipping of "confidential material information that is not legally available to others," while permitting unrestricted use of information gotten through superior "diligence," "acumen," and "honest means" (445 U.S. at 251, 252 n.2). The evidence of crime at issue in this case was not withheld from members of the general public by force of law; petitioner acquired it solely through diligence, acumen, and honest means. Other analysts interested in investigating Equity Funding's operations were free to contact its former employees, several of whom made attempts to expose the fraud (Pet. App. A-9 to A-10 n.6; J.A. 15-16, 22-23, 36-37, 66-67, 96-97, 229). The fraudulent scheme was frequently discussed by company personnel, many of whom freely conferred with petitioner (Pet. App. B-9; J.A. 34, 36, 39-40, 234-236, 239-242, 257);[17] they expressed relief when it was inquired into (J.A. 241); and they demonstrated their willingness to confer with persons other than petitioner, including journalists, analysts, investors, and government officials (J.A. 17-18, 35, 39-40, 50-51, 131, 201-202, 213, 226, 235, 246, 259, 270). Petitioner obtained the information in question through a combination of good fortune and diligent investigative technique, and in a free enterprise economy "advantages obtained by honest means" are entitled to "reap their full reward" (*Chiarella* v. *United States*, *supra*, 445 U.S. at 252 n.2). See Brudney, *supra*, 93 Harv. L. Rev. at 360-361, 365; see also Lorie, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy: A Comment*, 9 J. Legal Stud. 819, 821 (1980) ("in the *Equity Funding* case, the information was secured by the private initiative of someone who

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[17] "[I]t was common knowledge, all this, what he was telling me, * * * it was common knowledge around the water cooler where everybody talked about it" (J.A. 34).

enjoyed no privileged position with respect to access to information").[18]

III. Penalizing Petitioner For His Actions Will Undermine The Effectiveness Of Federal Law Enforcement And Impair The Policies Underlying The Prohibition Against Insider Trading

As Judge Wright observed (Pet. App. A-3), "[l]argely thanks to Dirks one of the most infamous frauds in recent memory was uncovered and exposed," while governmental authorities "repeatedly missed opportunities to investigate Equity Funding." The Commission also acknowledged petitioner's "important role in bringing [Equity Funding's] massive fraud to light" (*id.* at B-26), but concluded that its censure order would not "chill" other analysts in the "investigation of rumors" of similar corporate frauds (*id.* at B-25). We are not so sanguine about the impact of the Commission's order on the private investigation of corporate crime.[19]

1. Petitioner's reputation as a competent security analyst caused Secrist to approach him (J.A. 19-20), even though Secrist was reluctant to communicate with government authorities (*id.* at 15-16, 22, 36-37, 66-67). Petitioner spent several weeks investigating Secrist's allegations—on his own time, at his own expense, and despite substantial personal danger. The direct result of his investigation was that the price of Equity Funding stock fell dramatically, trading was suspended, and government authorities ultimately took remedial action. As the principal architect of the Equity Funding fraud con-

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[18] Petitioner did not himself make any stock trades on the basis of the information he received (J.A. 154). His business reputation and the commercial interests of his firm, however, apparently were advanced by his investigative activities (Pet. App. B-6 to B-7).

[19] The prohibition announced in the Commission's opinion is backed not only by administrative sanctions, but also by potentially "Draconian" civil liabilities (*Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, *supra*, 495 F.2d at 242).

ceded, petitioner deserves "personal credit" for uncovering it (J.A. 115). Had petitioner not taken action, the illegal scheme, which lasted for nearly a decade, could have persisted for an additional period of time—causing even greater injury to the public (J.A. 64, 116-117).[20]

If the Commission's decision is allowed to stand, few analysts, brokers, or other securities professionals who hear rumors of corporate crime can be expected to follow a similar course. Investigative efforts are costly, and if private parties who are in the business of ferreting out and analyzing information are not allowed to trade with or even transmit their findings until the information is fully disclosed to the public at large, they will have no reason to undertake their investigation at all.[21] While, of course, the Commission has not prohibited analysts from exploring public records to substantiate rumors of criminal conduct, few corporate conspiracies can be uncovered without obtaining information from an inside source. The Commission's approach, therefore, is certain to reduce, and may well eliminate, the role of securities professionals in detecting and analyzing major corporate crimes.[22]

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[20] Surprisingly, the Commission's opinion attempts to minimize the extent of petitioner's investigative work (Pet. App. B-18). In our view, the record fully supports the court of appeals' conclusion that petitioner served as a highly effective private "detective" (Pet. App. A-3), obtaining corroboration of facts upon which government authorities were unable to take prompt action. See Testimony of Stanley Sporkin, C.A. App. 1076: "We were really in a quandry, on the week of March 26, about what we should do. We had no real verification of the facts." See also Pet. App. A-9 to A-10 n.6; J.A. 273.

[21] See Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 Sup. Ct. Rev. 309, 337 ("Dirks's efforts were costly. * * * The ability to pass secret information to clients enabled Dirks to profit from his investigation, which redounded to everyone's benefit.").

[22] See Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. Legal Stud. 801, 818 (1980) ("the SEC's Equity Funding position is [an unintended] boon to the successful commis-

In our view, such a result would have a significant adverse effect on federal law enforcement. The resources available to government law enforcement agencies are limited, and private parties with a financial incentive to pursue evidence of wrongdoing provide a valuable supplement (see Pet. App. A-25 to A-26).[23] That is particularly true in the securities industry, where analysts have the expertise and resources to investigate rumors, and a strong incentive to arrive at the truth about alleged corporate wrongdoing.

2. As the Commission correctly observed (Pet. App. B-12 to B-13; footnote omitted), "market efficiency in pricing is significantly enhanced by [the analyst's] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors." Until the Equity Funding fraud was exposed, as the Commission stated in its Brief in Opposition, "the information in the market in which the company's securities had been trading was grossly inaccurate" (*id.* at 2).

Market efficiency is not, of course, an excuse for insider trading, as the Commission has explained (Pet. App. B-13). It cannot justify an insider's misappropriation of confidential information, available only for a bona fide corporate purpose. Such conduct not only harms the corporation, but also violates the insider's fiduciary duty to shareholders, and ultimately impairs investor confidence in the public securities markets. See *In re Faberge, Inc.*, 45 S.E.C. 249, 254 (1973). Market efficiency need not depend upon insider trading because corporations, acting

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sion and prolongation of corporate fraud"). Accord, Easterbrook, *supra*, 1981 Sup. Ct. Rev. at 337 ("Dirks did everyone a service. The sooner frauds are discovered—and the more costs a defrauder bears in deferring disclosure—the fewer frauds there will be.").

[23] This point is a familiar one to the SEC. See, e.g., *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 432 (1964).

in compliance with the law, are required to promptly divulge all material facts that are relevant to investors.[24]

The situation is quite different, however, when the information in question is not confidential corporate information, subject to periodic disclosure requirements, but evidence of an ongoing criminal conspiracy involving those who control the company. Such information will never become public through the Commission's mandatory disclosure requirements: it will be reflected in the market price of securities only if someone conducts an effective investigation, precisely as petitioner did.

3. Considerations of fairness to investors, and the need to preserve investor confidence in the public securities markets, while strongly supporting the traditional rule against insider trading and tipping, provide no support for the Commission's decision here.

The Commission's decision in this case threatens to undermine, rather than enhance, investor confidence. If administrative rulings strip away the incentive of security analysts to investigate frauds, there will be more frauds in the future and they will persist for longer periods of time. By contrast, if investors may continue to expect that competent analysts, acting in their own economic interest, will assist the government in policing the securities markets, their reliance on the integrity of the marketplace will be strengthened.

Finally, no consideration of fairness requires the result reached by the Commission. Petitioner, unlike the defendants in traditional insider trading cases, did not misappropriate information, did not violate any fiduciary duty to stockholders, and did not exploit any privileged

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[24] Prompt disclosure is required by the SEC's periodic disclosure rules, as well as the rules of the exchanges on which the corporation's securities are traded. See II L. Loss, *Securities Regulation* 805, 809-823 (2d ed. 1961). See especially SEC Release No. 34-8995, *Timely Disclosure of Material Corporate Developments*, 35 Fed. Reg. 16733 (1970), reproduced in 2 Fed. Sec. L. Rep (CCH) ¶ 23,120A; see also *id.* at ¶ 23,121.

access "to confidential information that the honest investor, no matter how diligently he tried, could not legally obtain" (*Chiarella, supra*, 445 U.S. at 247 (Blackmun, J., dissenting)). Instead, he obtained his information through honest and costly investigation, and few—if any—investors would believe it unfair for him to profit thereby.

It was inevitable that the Equity Funding fraud would have victims. Because of petitioner's actions leading to the discovery of the fraud, there were fewer victims than there otherwise would have been (J.A. 64, 116-117). And to the extent that private parties retain an incentive to act as petitioner acted, there are likely to be fewer victims of such frauds in the future.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

REX E. LEE
Solicitor General

D. LOWELL JENSEN
Assistant Attorney General

STEPHEN M. SHAPIRO
Special Assistant to the Solicitor General

ROGER M. OLSEN
Deputy Assistant Attorney General

DAVID A. STRAUSS
Assistant to the Solicitor General

GEOFFREY S. STEWART
Attorney

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VERSUS SEC

Entry	Date	Note	Proceedings and Orders
1	Aug 17 1982	G	Petition for writ of certiorari filed.
3	Sep 16 1982		Order extending time to file response to petition until October 19, 1982.
4	Oct 19 1982		Brief of respondent SEC in opposition filed.
5	Oct 27 1982		DISTRIBUTED. November 12, 1982
6	Oct 29 1982	X	Reply brief of petitioner Raymond L. Dirks filed.
7	Nov 5 1982	X	Supplemental brief of respondent SEC filed.
8	Nov 15 1982		Petition GRANTED. **********
9	Dec 30 1982		Joint appendix filed.
10	Dec 30 1982		Brief of petitioner Raymond L. Dirks filed.
11	Dec 30 1982		Brief amicus curiae of Securities Industry Assn. filed.
12	Dec 30 1982		Brief amicus curiae of United States filed.
13	Jan 28 1983		Brief of respondent SEC filed.
14	Feb 15 1983		SET FOR ARGUMENT. Monday, March 21, 1983. (3rd case)

CONTINUE {

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